

7th Edition



Form Your Own Limited Liability Company

Attorney Anthony Mancuso,
author of *Your Limited Liability
Company: An Operating Manual*

- Create an LLC in any state
- Protect your personal assets
- Get tax benefits



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Attorney Anthony Mancuso



SEVENTH EDITION	SEPTEMBER 2011
Editor	MARCIA STEWART
Book & Cover Design	SUSAN PUTNEY
Proofreader	ELAINE MERRILL
Index	ELLEN SHERRON
Printing	BANG PRINTING

Mancuso, Anthony.

Form your own limited liability company / by Anthony Mancuso. — 7th ed.

p. cm.

Includes index.

Summary: "Step-by-step instructions and all the forms needed to create a limited liability corporation (LLC) in any state. It covers basic LLC legalities and taxation. The 7th edition includes the most recent changes in LLC law and related tax law"—Provided by publisher.

ISBN 978-1-4133-1624-7 (pbk.) — ISBN 978-1-4133-1654-4 (epub e-book)

1. Limited partnership—United States—Popular works. 2. Private companies—United States—Popular works. I. Title.

KF1380.M36 2011

346.73'0668—dc22

2011017137

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Acknowledgments

The author thanks Marcia Stewart for editing and organizing the material for this edition.
A special thanks to the entire Nolo crew for producing and publishing this book.

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Tony is the author of many Nolo books on forming and operating corporations (profit and nonprofit) and limited liability companies. Among his current books are *Incorporate Your Business*; *The Corporate Records Handbook*; *How to Form a Nonprofit Corporation*; *Nonprofit Meetings, Minutes & Records*; *LLC or Corporation?* and *Your Limited Liability Company: An Operating Manual*. His books have shown over a quarter of a million businesses and organizations how to form and operate a corporation or LLC.

Tony has lectured at Boalt School of Law on the U.C. Berkeley campus (*Using the Law in Non-Traditional Settings*) and at Stanford Law School (*How to Form a Nonprofit Corporation*). He taught Saturday Morning Law School business formation and operation courses for several years at Nolo's offices in Berkeley. He has also scripted and narrated several audiotapes and podcasts covering LLCs and corporate formations and other legal areas for Nolo as well as for The Company Corporation. He writes articles for and hosts the Nolo blog, LLC and Corporation Small Talk (www.llccorporationblog.com). He has given many recorded and live radio and TV presentations and interviews covering business, securities, and tax law issues. His law and tax articles and interviews have appeared in the *Wall Street Journal* and *TheStreet.Com*.

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To access Tony's LLC and corporation blogs and podcasts, plus links to his books and electronic titles, go to www.nolo.com/law-authors/anthony-mancuso.html.

Downloading Forms and Other Materials

The print version of this book comes with a CD-ROM that contains legal forms and other material. You can download that material by going to **www.nolo.com/back-of-book/LIAB7.html**. You'll get editable versions of the forms, which you can fill in or modify and then print.

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Your LLC Companion

Running a business is an exciting experience. It may mean pursuing a lifelong passion, investing in a creative opportunity, or just formalizing an already flourishing venture. But along with the excitement come new responsibilities: choosing the type of business entity that best suits your needs, understanding how to follow the legal and tax requirements for forming that entity, and working with business partners and associates to make decisions that everyone can agree on, to name a few. At the same time, you're probably trying to do it all without breaking the bank. And if you're considering forming a limited liability company, or LLC, you doubtlessly have another important consideration: limiting your personal liability for business debts or claims.

This book gives you the information and forms you need to make an informed choice on whether to form an LLC, either from scratch or by converting an existing partnership.

Both the print copy and eBook versions include tear-out versions of the forms (found in Appendix B) and filled-in samples in the text. If you're reading a print copy of this book, you'll find copies of the articles of organization and other forms in this book on the CD-ROM that comes with the book. If you're using an eBook version, you can download these forms on the Nolo website; the link is included in Appendix C.

This book also provides helpful information and forms for existing LLCs, such as information about ongoing legal formalities and instructions for preparing minutes of LLC meetings.

Readers who decide to set up business as an LLC will find information on how to form one in their states. You'll learn:

- which state administrative offices to contact
- how to prepare standard organizational and operational documents to get your LLC started, including LLC articles of organization and an LLC operating agreement, and
- how to comply with legal rules for your state.

The typical candidates for forming an LLC are business associates, friends, or family members who decide to pool energies and resources to own and operate a business. With few exceptions, all types of businesses may form an LLC. You may even form one LLC to engage in several businesses—for example, furniture sales, trucking, and redecorating all under one legal, if not physical, roof.

There are many advantages to forming an LLC, as explained in “Top Ten Questions,” in Chapter 1. Are there any disadvantages to forming an LLC? Not many. Just a few forms and fees. This book alerts you to pitfalls you

may encounter along the way and provides instructions on how to fill in all the necessary paperwork. And when there's a question about whether you need an expert's advice on a particular legal or tax issue, we are quick to point it out. Don't let the small print stop you—most LLCs organizers do not have to worry about the finer points of LLC law and taxation when they form an LLC; and if they run into complexities later, they can find a legal or tax expert to help them out.

In general, we recommend checking with a small business tax or legal adviser before taking the plunge and filing your papers with the state. Expert advice will ensure that an LLC is your best choice, that you have up-to-date state-specific information, and that you have considered all legal and tax angles that apply to your business.

We are confident that a careful reading of this book can help make you an informed LLC organizer, manager, and member. We wish you all the best on the road to forming and running a successful LLC. ●

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In this chapter, we'll cover the nuts and bolts of the limited liability company, or LLC: the most common questions, the primary benefits, which businesses should choose LLC status, and what other types of business entities there are. We'll delve into the specific legal and tax characteristics of LLCs in the next two chapters.



SKIP AHEAD

If you are familiar with LLCs. If you have followed the development of the LLC over the last few years and know its general legal and tax characteristics (or you simply want to look at the specifics of forming an LLC right now), you can skip the introductory material in this and the following two chapters. Move right ahead to Chapter 4, where you'll learn how to prepare LLC articles of organization.

Top Ten Questions About LLCs

1. What Is an LLC?

An LLC is a business structure that gives its owners corporate-style limited liability, while at the same time allowing partnership-style taxation.

- Like owners of a corporation, LLC owners are protected from personal liability for business debts and claims—a feature known as “limited liability.” This means that if the business owes money or faces a lawsuit, the assets of the business itself are at risk but usually not the personal assets of the LLC owners, such as their houses or cars.
- Like owners of partnerships or sole proprietorships, LLC owners report their share of the business profits or losses on their personal income tax returns. The LLC itself is not a separate taxable entity.

Because of these attributes, the LLC fits somewhere between the partnership and the corporation (or, for one-owner businesses, the sole proprietorship and the one-person corporation).

2. How Many People Do I Need to Form an LLC?

You can form an LLC with just one owner. For reasons we'll explain later, LLCs are appropriate for businesses with no more than 35 owners and investors.

3. Who Should Form an LLC?

Consider forming an LLC if you are concerned about personal exposure to lawsuits arising from your business. For example, an LLC will shield your personal assets from:

- suppliers' claims for unpaid bills, and
- for businesses that deal directly with the public, slip-and-fall lawsuits that your commercial liability insurance policy may not adequately cover.

Not all businesses can operate as LLCs, however. Those in the banking, trust, and insurance industries, for example, are typically prohibited from forming LLCs. Some states (including California) prohibit special licensed professionals such as accountants, doctors, lawyers, and some other state-licensed practitioners from forming LLCs. Many of these professionals may benefit from forming a limited liability *partnership*.

4. How Do I Form an LLC?

In most states, the only legal requirement to form an LLC is that you file articles of organization with your state's LLC filing office, which is usually part of the Secretary of State's office. (Several states refer to this organizational document as a “certificate of organization” or a “certificate of formation.”) A few states require

an additional step: Prior to or immediately after filing your articles of organization, you must publish your intention to form an LLC, or a notice that you have formed an LLC, in a local newspaper. We'll explain how to prepare and file articles of organization in Chapter 4.

5. Do I Need a Lawyer to Form an LLC?

You don't need a lawyer. In most states, the information required for the articles of organization is simple—it typically includes the name of the LLC, the location of its principal office, the names and addresses of the LLC's owners and/or managers, and the name and address of the LLC's registered agent (a person or company that agrees to accept legal papers on behalf of the LLC).

The process itself is simple, too. Most states have fill-in-the-blank forms and instructions that can be downloaded. Some states even let you prepare and file articles online at the state filing website, which means you can create your LLC in a matter of minutes. LLC filing offices increasingly allow owners to send them email questions, too. We alert you to situations throughout this book when a lawyer's advice will be useful and include a discussion in Chapter 8 on how to find and work cost-effectively with an experienced business lawyer.

6. Does My LLC Need an Operating Agreement?

Although most states' LLC laws don't require a written operating agreement, don't even consider starting an LLC without one. An operating agreement is necessary because it:

- sets out rules that govern how profits and losses will be split up, how major business decisions will be made, and the procedures for handling the departure and addition of members

- keeps your LLC from being governed by the default rules in your state's LLC laws, which might not be to your benefit, and
- helps ensure that courts will respect your personal liability protection, because it shows that you have been conscientious about organizing your LLC.

In Chapters 5 and 6, you'll learn how to create an operating agreement.

7. How Do LLCs Pay Taxes?

Like partnerships and sole proprietorships, an LLC is not a separate entity from its owners for income tax purposes. This means that the LLC itself does not pay income taxes. Instead, the LLC owners use their personal tax returns to pay tax on their allocated share of profits (or deduct their share of business losses).

LLC owners can elect to have their LLC taxed like a corporation. This may reduce taxes for established LLC owners who will regularly need to keep a significant amount of profit in the company.

These tax consequences will be discussed in detail in Chapter 3, and Chapter 8 explains how to find the right tax adviser for your business.

8. What Are the Differences Between a Limited Liability Company and a Partnership?

The main difference between an LLC and a partnership is that LLC owners are not personally liable for the company's debts and liabilities. Partners, on the other hand, do not have this limited liability protection. Also, owners of limited liability companies must file formal articles of organization with their state's LLC filing office, pay a filing fee, and comply with other state filing requirements before they open for business. Partners don't need to file any formal paperwork and don't have to pay special fees.

LLCs and partnerships are almost identical when it comes to taxation, however. In both types of businesses, the owners report business income or losses on their personal tax returns. In fact, co-owned LLCs and partnerships file the same informational tax return with the IRS (Form 1065) and distribute the same schedules to the business's owners (Schedule K-1, which lists each owner's share of income).

9. Can I Convert My Existing Business to an LLC?

Converting a partnership or a sole proprietorship to an LLC is an easy way for partners and sole proprietors to protect their personal assets without changing the way their business income is taxed. Some states have a simple form for converting a partnership to an LLC (often called a “certificate of conversion”), as described in Chapter 4. Partners and sole proprietors in states that don't use a conversion form must file regular articles of organization to create an LLC.

10. Do I Need to Know About Securities Laws to Set Up an LLC?

If you'll be the sole owner of your LLC, which you will manage and operate, and you don't plan to take investments from outsiders, your ownership interest in the LLC is not a “security” and you don't have to concern yourself with these laws. For co-owned LLCs, however, the answer to this question is a bit more involved.

If all of the owners of your LLC will actively manage the LLC, their ownership interests in the company will usually not be treated as securities. However, when someone invests in your business expecting to make money from the efforts of others, that person's investment is generally considered a security under federal and state law.

If your LLC's ownership interests are considered securities, you must get an exemption from the state and federal securities laws before the initial owners of your LLC invest their money. Fortunately, smaller LLCs, even those that plan to sell memberships to passive investors, usually qualify for securities law exemptions.

We'll explain this further in Chapter 2.

The Benefits of LLCs

The LLC stands as a unique alternative to five traditional legal and tax ways of doing business: sole proprietorships, general partnerships, limited partnerships, C corporations (also called “regular” corporations), and S corporations. While these business entities offer *some* of the same benefits as LLCs, none offer *all* of the same benefits. The combination of structural and tax benefits unique to LLCs includes:

- limited liability status
- taxation of business profits at individual rates
- flexible management structure, and
- flexible distribution of profits and losses.

Limited Liability Status

The legal characteristic most interesting to business owners is undoubtedly the limited liability status of LLC owners. With the exception of corporate entities, the LLC is the only form of legal entity that lets *all* of its owners off the hook for business debts and other legal liabilities, such as court judgments and legal settlements obtained against the business. Another way of saying this is that an investor in an LLC normally has at risk only his or her share of capital paid into the business.

There's Never Limited Liability for Personally Guaranteed Debts

No matter how a small business is organized (LLC, corporation, partnership, or sole proprietorship), its owners must normally cosign business loans made by banks—at least until the business establishes its own positive credit history.

When you cosign a loan, you promise to voluntarily assume personal liability if your business fails to pay back the loan. In some cases, the bank may ask you to pledge all your personal assets as security; in others, it may only require you to pledge specific personal assets—for example, the equity in your home.

EXAMPLE:

A married couple owns and operates Books & Bagels, a coffee shop and bookstore. In need of funds (dough, really) to expand into a larger location, the owners go to the bank to get a small loan for their corporation. The bank grants the loan on the condition that the two owners personally pledge their equity in their house as security for the loan. Because the owners personally guaranteed the loan, the bank can seek repayment from the owners personally by foreclosing on their home if Books & Bagels defaults. No form of business ownership can insulate them from the personal liability they agreed to.

For more information about pledging personal assets to secure business loans, see *Legal Guide for Starting & Running a Small Business*, by Fred Steingold (Nolo).

Business Profits and Losses Taxed at Individuals' Income Tax Rates

The LLC is recognized by the IRS as a “pass-through” tax entity. That is, the profits or losses of the LLC pass through the business and are reflected and taxed on the individual tax returns of the owners, rather than being reported and taxed at a separate business level. (Other pass-through entities include general and limited partnerships, sole proprietorships, and S corporations—those that have elected S corporation tax status with the IRS.) We'll discuss pass-through taxation further, below.

Flexible Management Structure

LLC owners are referred to as members. A member may be an individual or a separate legal entity, such as a partnership or corporation. Members invest in the LLC and receive percentage ownership interests in return. These ownership interests are used to divide up the assets of the LLC when it is sold or liquidated and are typically used for other purposes as well—for example, to split up profits and losses of the LLC or to divide up members' voting rights.

LLCs are run by their members unless they elect to be managed by a management group, which may consist of some members and/or nonmembers. Small LLCs are normally member managed—after all, most small business owners want and need to have an active hand in the management of the business. However, this isn't always true. Especially with a growing business or one that makes fairly passive investments, such as in real estate, investors may not want a day-to-day role. Fortunately, an LLC can easily adopt a management-run structure in situations such as these:

- the members want the LLC to be managed by some, but not all, members
- the members decide to employ outside management help, or
- the members choose to cater to an outsider who wishes to invest in or loan capital to the LLC in exchange for a vote in management.

Uniform LLC Laws

For many years, legal scholars and state legislators have worked hard to have all states adopt the same (or very similar) laws affecting key areas of American business and life. Efforts are being made to adopt a national model LLC act that can be used by individual state legislatures to pass future LLC legislation. One model is the Prototype Limited Liability Company Act, sponsored by the American Bar Association's Section of Business Law. Another is the Uniform Limited Liability Company Act, developed by the National Conference of Commissioners on Uniform State Laws.

Usually, states adopt portions of the model acts to supplement their current LLC statutes. In short, while LLC laws are fairly similar (they generally try to conform to IRS regulations and to LLC statutory schemes in other states), state-by-state differences remain.

Flexible Distribution of Profits and Losses

An LLC allows business owners to split profits and losses any way they wish (this flexibility is afforded partnerships as well). You are not restricted to dividing up profits proportionate to the members' capital contributions (the standard legal rule for corporations).

EXAMPLE:

Steve and Frankie form an educational seminar business. Steve puts up all the cash necessary to purchase a computer with graphics and multimedia presentation capabilities, rent out initial seminar sites, send out mass mailings, and purchase advertising. As the traveling lecturer, cash-poor Frankie will contribute services to the LLC. Although the two owners could agree to split profits and losses equally, they decide that Steve will get 65% of the business's profits and losses for the first three years as a way of paying him back for taking the risk of putting up cash.

By contrast, rules governing the distribution of corporate profits and losses are fairly restrictive. A C corporation cannot allocate profits and losses to shareholders at all—shareholders get a financial return from the corporation by receiving dividends or a share of the corporation's assets when it is sold or liquidated. In an S corporation (covered in detail below), profits and losses generally must follow shareholdings. For example, an S corporation shareholder holding 10% of the shares ordinarily must be allocated a 10% share of yearly profits and losses.

There are a few wrinkles in the flexibility afforded to LLCs. Because LLCs are treated like partnerships for tax purposes, LLCs must comply with technical partnership tax rules:

- **Tax laws require special (disproportionate) allocations of LLC profits or losses to have “substantial economic effect.”** In Chapter 3, we'll discuss exactly what that means and how to help make sure your LLC complies with the requirement. For now, simply understand that the purpose of the rule is to ensure that the members have

corresponding economic benefits and risks for profits and losses allocated to them.

- **Members contributing services to the LLC may be subject to income taxes on the value of their services.** Again, we'll discuss the tax effects of a member's future personal services to the LLC in Chapter 3.

Which Businesses Benefit as LLCs?

Here is an overview of the types of persons and businesses for which the LLC form makes the most and least sense. These guidelines aren't set in stone—certainly you may find that your business breaks the mold.

Businesses That Benefit From the LLC Structure

LLCs generally work best for:

- **Actively run businesses with a limited number of owners.** The logistics of making collective business decisions are manageable with a maximum of around 35 owners.
- **Small new businesses.** New businesses generally wish to pass early-year losses along to owners to deduct against their other income (usually salary earned working for another company or income earned from investments).
- **Anyone thinking of forming an S corporation.** Like LLCs, S corporations provide limited liability protection to all owners and allow profits and losses to be taxed at individual shareholder rates. However, as we'll discuss in "S corporations," below, these benefits come at a pretty high price: S corporations are significantly restrictive and a business can inadvertently lose its eligibility—for example, when a disqualified shareholder

inherits or buys stock—resulting in a big tax bill.

- **Existing partnerships.** Only the LLC provides partnership-style pass-through tax treatment of business income while insulating *all* owners (not just limited partners as in a limited partnership) from personal liability for business debts.

- **Businesses planning to hold property that will appreciate, such as real property.**

C corporations and their shareholders are subject to a double tax on appreciation when assets are sold or liquidated—taxation occurs at both the corporate and individual level. S corporations that were originally organized as C corporations may also be subject to double tax on gains from appreciated assets, as well as a penalty tax on passive income (money from rents, royalties, interest, or dividends) if it gets too high. Because the LLC is a true pass-through tax entity, it allows a business that holds appreciating assets to avoid double taxation.

Businesses That Normally Should Not Form an LLC Using This Book

The LLC is not normally suitable for:

- **Existing S or C corporations.** While it may be possible to convert an existing corporation to an LLC without hefty tax or legal costs, you'll need the help of a lawyer and a tax adviser to make sure you don't get stung.
- **Highly profitable LLCs in certain states.** Some states have a graduated LLC license fee schedule, meaning the more profitable the LLC, the higher the tax. In California, for example, LLCs with gross income over \$5 million must pay an annual fee of approximately \$12,000. Such a stiff tax is unusual; check on your state tax website (see Appendix A) or ask your tax adviser to

find out whether you face this unpleasant prospect. Of course, in states with a high LLC fee or tax, chances are good that the state also has enacted fees that apply to other pass-through tax entities (limited partnerships and S corporations). In these states, you may decide that forming a general partnership, which isn't taxed separately, is the least expensive way to go—but you won't qualify for limited liability for business debts.

Comparing LLCs and Other Business Forms

Anyone considering an LLC will want to compare this business form to the three traditional ways of doing business:

- sole proprietorships
- partnerships, and
- C corporations.

In addition, to fully understand the pros and cons of LLC status, you'll need to compare the LLC to two variants on these traditional business forms that come closest to resembling the legal and tax characteristics of the LLC:

- limited partnerships, and
- S corporations.

This section provides general information on the characteristics of each type of legal entity, focusing on the main reasons why businesspeople adopt one form over another. Our aim is to explain most of the information you'll need to decide whether the LLC is right for you. However, please realize that we can't cover every nuance of tax and business organization law as it applies to your business. Furthermore, the area of pass-through taxation is no piece of cake, even to tax specialists. You may need to check with a tax adviser to make sure the LLC makes sense to you from a tax standpoint, and

to learn about any of the special tax areas (some of which are covered in Chapter 3) that may have special relevance to your business. For a quick overview of the different legal and tax characteristics of the various entities, see the business entity comparison chart, at the end of this chapter.

Other Ways of Doing Business: More Information From Nolo

For further examination of the legal and tax characteristics of the various ways of doing business, see the following Nolo titles:

- ***LLC or Corporation?***, by Anthony Mancuso. This book explains in depth the legal and tax differences between LLCs and corporations, as well as the legal and tax effects of different forms of doing business as a company grows.
- ***Form a Partnership: The Complete Legal Guide***, by Denis Clifford and Ralph Warner. This book discusses general partnerships and shows you step by step how to prepare a general partnership agreement.
- ***Incorporate Your Business: A Legal Guide to Forming a Corporation in Your State*** and ***How to Form Your Own California Corporation***, by Anthony Mancuso. These books provide in-depth treatment of the corporate structure and show you how to incorporate in each state. Incorporation forms are included as tear-outs and on CD-ROMs.

Sole Proprietorship

The simplest way of being in business for yourself is as a sole proprietor. This is just a fancy way of saying that you are the owner of a one-person business. There's little red tape and cost—other than the usual business licenses,

sales tax permits, and local and state regulations that any business must face. As a practical matter, most one-person businesses start out as sole proprietorships just to keep things simple.

Sole Proprietorship Is Limited to One Person

If your sole proprietorship grows, you'll need to move to a more complicated type of business structure. Once you decide to own and split profits with another person (other than your spouse), by definition, you have at least a partnership on your hands.

Sole Proprietor Is Personally Liable for Business Debts

Unfortunately, although a sole proprietorship is simple, it can also be a dangerous way to operate, especially if the work you do might result in large debts or liabilities from lawsuits. The sole proprietor is personally liable for all debts and claims against a business. For example, if someone slips and falls in a sole proprietor's business and sues, the owner is on the line for paying any court award (if commercial liability insurance doesn't cover it). Similarly, if the business fails to pay suppliers, banks, or other businesses' bills, the owner is personally liable for the unpaid debts. The owner's personal assets, such as a home, car, and bank accounts, are fair game for repayment of these amounts.

Sole Proprietor's Taxes

Sole proprietors report business profits or losses on IRS Schedule C, *Profit or Loss From Business (Sole Proprietorship)*, included with a Form 1040 individual federal tax return. Profits are taxed at the owner's individual income tax rates.

Because the owner is self-employed, he or she must pay an increased amount of self-employment (FICA) tax based upon these profits—about twice as much as an

incorporated business or corporate employee would personally pay. This increased FICA tax doesn't necessarily mean that sole proprietorships are more expensive tax-wise than other business forms. For instance, if you are both a corporate shareholder and employee, as is the case for the owner/employees of most small corporations, you end up paying a similar amount of total FICA taxes.

Sole Proprietorships Compared to LLCs

The LLC requires more paperwork to get started and is more complicated than a sole proprietorship from a legal and tax perspective. Although LLC owners, like sole proprietors, report business profits on their individual tax returns, the co-owned LLC itself is treated as a partnership and must prepare its own annual informational tax return. The payoff of the LLC for this added complexity is that owners are not personally liable for business claims or debts (unless personally guaranteed, as with a personally guaranteed bank loan).

General Partnerships

A partnership is a business in which two or more owners agree to share profits. If you go into business with at least one other person and you don't file formal papers with the state to set up an LLC, corporation, or limited partnership, the law says you have formed a general partnership. A general partnership can be started with a handshake (a simple verbal agreement or understanding) or a formal partnership agreement.



CAUTION

Partners should always create a written partnership agreement. Without an agreement, the default rules of each state's general partnership law apply to the business. These provisions usually say that profits and losses of the business should be

If You Own a Business With Your Spouse

Generally, if a husband and wife run an unincorporated business together and share in its profits and losses, they are considered the co-owners of a partnership, not a sole proprietorship, and they must file a partnership tax return for the business. However, if one spouse manages the business and the other helps out as an employee or volunteer worker (but does not contribute to running the business), the managing spouse can claim ownership and treat the business as a sole proprietorship.

Another exception to the general rule that a spouses' business is considered a partnership occurs when all of the following four criteria are met:

1. The business is unincorporated and is not a state-created business entity such as an LLC or limited partnership.
2. The only members of the business are a husband and wife who file a joint 1040 tax return.
3. Both spouses materially participate in the trade or business.
4. Both spouses elect not to be treated as a partnership (the spouses do not file a separate partnership return for the business).

In this case, the spouses can elect to divide up the profits of the business and report them separately for each spouse on their joint 1040 tax return. They do this by filing two Schedule Cs (one for each spouse) with their joint 1040 tax return, showing each spouse's share of profits on a separate Schedule C. Each spouse must also file a self-employment tax schedule (Schedule SE) to pay self-employment tax on his or her individual share of the profits. If the spouses qualify for this exception, each spouse gets Social Security credit for his or her share of earnings in the business.

What if spouses jointly run a state business entity such as an LLC? In this case, the spouses will normally be treated as partners and must file a partnership tax return for the LLC. However, there is yet another special exception to partnership tax treatment available in several states. Specifically, IRS rules say that an unincorporated business that is owned solely by a husband and wife as community property in the community property states of Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin can treat itself as a sole proprietorship by filing an IRS Form 1040 Schedule C for the business, listing one of the spouses as the owner. Only the listed spouse pays income and self-employment taxes on the reported Schedule C net profits. This means only the listed Schedule C owner-spouse will receive Social Security account earning credits for the Schedule SE taxes paid with the 1040 return. For this reason, some eligible spouses will decide not to make this Schedule C filing and will continue to file partnership tax returns for their jointly owned spousal LLC. Also note that the IRS treats the filing of a Schedule C for a jointly owned spousal LLC as the conversion of a partnership to a sole proprietorship, which can have tax consequences.

For more information on spousal businesses, see the section titled "Community property," in the IRS Publication 541 section on "Forming a Partnership," and other information on the IRS website, at www.irs.gov. In all cases, be sure to check with your tax adviser before deciding on the best way to own, and file and pay taxes for, a business you own with your spouse.

split up equally among the partners, regardless of the amount of capital contributed to the business by each partner. Rather than relying on state laws, general partners should prepare an agreement that covers issues such as the division of profits and losses, the payment of salaries and draws to partners, and the procedure for selling partnership interests back to the partnership or to outsiders.

Number of Partners in a General Partnership

General partnerships may be formed by two or more people; there is no such thing as a one-person partnership. Legally, there is no upper limit on the number of partners who may be admitted into a partnership, but general partnerships with many owners may have problems reaching a consensus on business decisions and may be subject to divisive disputes between contending management factions.

General Partnership Liability

Each owner of a general partnership is individually liable for the debts and claims of the business. In other words, if the partnership owes money, a creditor may go after any member of the partnership for the entire debt, regardless of that member's ownership percentage (although one partner can sue other partners to force them to repay their shares of the debt).

In addition, each partner may bind the partnership to contracts or enter a business deal that binds the partnership, as long as the contract or deal is within the scope of business undertaken by the partnership. In legal jargon, this authority is expressed by saying that each partner is an “agent” of the partnership.

The personal liability for partnership debts, coupled with the agency authority of each partner, makes the general partnership riskier than limited liability businesses (corporations, LLCs, and limited partnerships).

General Partnership Taxes

A general partnership is not a separate taxable entity. Profits (and losses) pass through the business to the partners, who pay taxes on profits at their individual tax rates. Although the partnership does not pay its own taxes, it must file an information return each year—IRS Form 1065, *U.S. Return of Partnership Income*. The partnership must give each partner a filled-in IRS Schedule K-1 (Form 1065), *Partner's Share of Income, Deductions, Credits, etc.*, which shows the proportionate share of profits or losses each person carries over to his or her individual 1040 tax return at the end of the year.

General Partnerships Compared to LLCs

General partnerships are less costly to start than LLCs because most states do not require a state filing (and fees) to form them. The major downside to running a general partnership over an LLC is the exposure to personal liability by each of the general partners. Although a general business insurance package (possibly supplemented by more specialized coverage for unusual risks) can mitigate possible effects, each partner is still personally responsible for all business debts and for any liabilities not covered by the business's insurance policy. LLC owners, on the other hand, avoid this personal liability problem altogether.

General partnerships and LLCs come out about even on a couple of important issues:

- **Partnership agreement or operating agreement.** Even small partnerships and LLCs should start off with a good written partnership agreement or operating agreement. This, of course, takes time and if you don't do the work yourself, is likely to cost \$1,000 to \$5,000 in legal fees, depending on the complexity of your business and the thickness of your lawyer's rug. (We help you

prepare an operating agreement in Chapters 5 and 6 of this book.)

- **Taxes.** General partnerships and LLCs can count on about the same amount of tax complexity, preparation time, and paperwork. Even though you'll probably turn over most year-end tax work to a tax adviser (for either a co-owned LLC or partnership), understanding and following basic partnership tax procedures takes a fair amount of time and effort.

C Corporations

To establish a C corporation, you prepare and file formal articles of incorporation papers with a state agency (usually the secretary of state) and pay corporate filing fees and initial taxes. A corporation assumes an independent legal and tax life separate from its owners, with the result that it pays taxes at its own corporate tax rates and files its own income tax returns each year (IRS Form 1120).

Corporations are owned by shareholders and managed by a board of directors. Most management decisions are left to the directors, although a few must be ratified by the shareholders as well, such as the amendment of corporate articles of incorporation, sale of substantially all of the corporation's assets, or the merger or dissolution of the corporation. Corporate officers are normally appointed by the board of directors to handle the day-to-day supervision of corporate business, and usually consist of a corporate president, vice president, secretary, and treasurer.



TIP

A C corporation is nothing more than a regular corporation. The letter "C" simply distinguishes the regular corporation (one taxed under normal corporate income tax rules) from a more specialized type of corporation regulated

under Subchapter S of the Internal Revenue Code, discussed in "S Corporations," below.

Number of Corporate Shareholders and Directors

In most states, one or more persons can form and operate a corporation. In a few states, the number of directors necessary for a multi-owner corporation is related to the number of shareholders. For example, if there are two shareholders, two or more directors must be named; if three shareholders, then three or more directors are necessary.

Corporate Limited Liability

As we have mentioned, a corporation provides all its owners (shareholders) with the benefits of limited liability—before other limited liability entities (such as the LLC) were available, that was a major reason many businesses organized as corporations.

Corporation's Separate Legal and Tax Existence

The corporation has a legal and tax existence separate from its owners. This leads to the following corporate characteristics:

- **Separate taxes.** A corporation files its own income tax return and pays its own income taxes.
- **Tax benefits of employee fringe benefits.** The corporate form allows owner-employees (shareholders who also work in the business) to deduct a number of corporate fringes paid to employees (including themselves) from corporate income, such as the direct reimbursement of medical expenses. Also, corporations can provide tax-favored stock bonus, stock option, and other equity-sharing plans for employees.

- **Legal formalities.** Because a corporation has a separate legal existence, you must pay more attention to its legal care. This means owners must don directors' and shareholders' hats and hold and document annual meetings required under state law. Owners must keep minutes of meetings, prepare other formal documentation of important decisions made during the life of the corporation, and keep a paper trail of all financial dealings between the corporation and its shareholders. Owners also need to tend to other formalities, such as appointing officers required under corporate statutes. A corporation should issue stock to its shareholders and keep adequate capital on hand to handle foreseeable business debts and liabilities.



CAUTION

Shoddy corporate procedures can cost you. It can be dangerous to set up a thinly capitalized corporation, treat corporate coffers as an incorporated pocketbook for your personal finances, fail to issue stock, neglect to hold meetings, or overlook other formalities required under your state's corporation code. If you do (or don't do) these things, a court or the IRS may "pierce the corporate veil" (a metaphor carried over from a long line of court cases) and decide that the corporation is simply an "alter ego" of the shareholders of a small corporation. If this happens, the business owners (shareholders) can be held personally liable for any money awarded by a court against the corporation.

Corporations Compared to LLCs

Corporations are similar to LLCs in the types of paperwork and fees necessary to get them started with the state. Both must prepare and file organizational papers with the secretary of state and pay filing fees. Both should adopt a set of operating rules that sets out the basic requirements for operating the business—

corporations adopt bylaws; LLCs adopt operating agreements.

What sets the corporate form apart from LLCs is how they are taxed. Corporations are taxed separately from their owners at corporate income tax rates. This can result in tax savings if money is left in a business for expansion or for other business needs. That's because initial tax rates applied to corporate income are normally lower than the individual tax rates of business owners.

EXAMPLE:

Justine and Janine own and operate Just Jams & Jellies, a specialty store selling gourmet canned preserves. Business has boomed and their net taxable income, split equally by the partners, has reached a level where it is taxed at an individual tax rate of over 30%. If the owners incorporate, or if they form an LLC and elect corporate tax treatment, they can keep money in their business, which is taxed at the lower corporate tax rates of 15% and 25%, saving overall tax dollars on business income.

This corporate tax distinction can be eliminated if the LLC members wish. That is, LLC members can elect to have their LLC taxed as a corporation. We'll discuss this option, and why some LLCs take it, in Chapter 3.

Even though an LLC may now elect corporate tax treatment, there may be other reasons to favor the corporate form over the LLC, such as the availability of corporate equity sharing plans. Also, a number of people—perhaps including persons you may wish to do business with—associate the corporate form with an added degree of formality and solidity. And, of course, the ability to go public (make a public offering of corporate shares) is a traditional feature of the corporate form that more

What About the Double Taxation of Corporate Profits?

You've probably read about the awful consequence of double taxation when a corporation makes money. Specifically, corporate profits are first taxed at the corporate level, then any profits paid out as dividends to shareholders are taxed at each shareholder's dividend tax rate. Doesn't this result in a big comparative advantage for LLCs that are taxed as partnerships, where the owners pay taxes just once on business income at their personal rates?

For small, actively run corporations, we say no. Here's why. To avoid the penalty of double taxation, smaller corporations rarely pay dividends to the owners. Instead, the owner-employees are paid salaries and fringe benefits that are tax deductible to the corporation. As a result, only employee-shareholders pay income taxes on this business income.

So cast a critical eye on any article decrying the double taxation of corporate profits for small businesses. Unless you are forming a corporation with passive investors who expect to receive regular dividends as a return on their investment in your corporation, double taxation will generally not be a big deal.

Exception: When (and if) appreciated assets of a corporation are sold, both the corporation and its owners may have to pay income taxes on profits from the sale. If you are thinking of incorporating, it's important to plan for this possibility of double taxation of sales proceeds received from the sale of appreciated assets (such as real estate that has risen in value).

successful small businesses may be able to capitalize on. (Forget about going public with an LLC; the practical and tax restrictions on transferring membership interests rule out this possibility.)

There are several downsides to corporate life. We've already mentioned the complexity of complying with state law corporate procedures by holding annual and special director and shareholder meetings. (Some states have tried to lessen the impact of these state-mandated formalities with the creation of the close corporation form—see the sidebar on the following page, “A Look at Close Corporations.”)

Limited Partnerships

A limited partnership is similar to a general partnership (discussed above), except that instead of being composed of general partners only, it has two types:

- **Limited partners.** One or more partners contribute capital to the business, but neither participates, in its day-to-day operations nor has personal liability for business debts and claims.
- **General partners.** One or more partners manage business operations and have personal liability for business debts and claims.

To get this special type of partnership started, you must file papers (certificate of limited partnership) with the state and pay an initial filing fee.

A Look at Close Corporations

Several states have enacted special corporate statutes that allow small corporations to dispense with normal operating rules. These corporations, called “close” or “statutory close” corporations, usually must meet a number of legal requirements:

- The corporation must have a limited number of shareholders, usually no more than 35.
- Shares of stock must not be sold or transferred to outsiders unless the transaction is approved by all shareholders.
- The corporation must elect close corporation status in its formation documents or in an amendment to these papers.
- The corporation must operate under partnership-type rules specified in a shareholders’ agreement. (The drafting of this agreement is time consuming and can involve fairly high attorney fees.)

Ten to 15 years ago, legislators in corporately active states, including California, Delaware, Illinois, and Texas, expected business organizers to line up to form close corporations under the newly enacted state laws, but few were formed. The close corporation’s failure to spark the interest of business organizers was due to the following reasons:

- Few corporations want to forego the customary formality of appointing a board of directors, electing officers, and assuming the other traditional accoutrements of corporate life.
- Management of a corporation by its shareholders is normally seen as novel and potentially chaotic.
- Preparation and adoption of a custom-tailored shareholders’ agreement is a time-consuming incorporation step most organizers want to avoid.
- Shareholders do not want restrictions on their right to sell or transfer shares, which are mandatory under typical close corporation statutes.

In many ways, the close corporation resembles the LLC by giving owners the protection of limited liability while allowing them to operate under partnership-type legal rules. The big difference is that unlike for LLCs, the IRS never bestowed the general mantle of pass-through tax treatment on close corporations. Had close corporations successfully obtained pass-through tax treatment with the IRS and been able to operate informally without having to prepare a special shareholders’ agreement, perhaps they would be vying today for the popular attention currently enjoyed by LLCs.

Number of Partners

Limited partnerships may be formed by two or more people, with:

- at least one person acting as the general partner, who has management authority and personal liability, and
- at least one person in the role of limited partner.

Limited Liability Only for Limited Partners

Limited partners enjoy the same kind of limited liability for the debts and liabilities of the business as do the shareholders of a corporation and the members of an LLC. General partners of limited partnerships, on the other hand, have the same personal liability described above for general partnerships.

Limited Partnership Taxes

For tax purposes, limited partnerships normally are treated like general partnerships, with all owners having to report and pay taxes personally on their share of the profits each year. The limited partnership files an informational tax return only, and is not subject to an entity level federal income tax.

Limited Partnerships Compared to LLCs

There are two major differences between limited partnerships and LLCs. First, a limited partnership must have at least one general partner, who is personally liable for the debts and other liabilities of the business. This differs from LLCs, where all members are covered by the cloak of limited liability.

Second, limited partners are generally prohibited from managing the business. A limited partner who becomes active in the business of the limited partnership typically loses the limited partner status with its attendant limited liability protection. (There are exceptions to this

ban under the newer Revised Uniform Limited Partnership Act, which has made the rounds through state legislatures and has been adopted, at least in part, in most states.) In contrast, LLC members are given a free hand in managing and running the business, either by themselves or in conjunction with outside managers.

This second restriction of the limited partnership makes it more of a gamble for investors, who must turn over management of the business to a general partner. Such an arrangement may work well for outsiders who want to invest cash or property in a business run by others, but it won't work well for businesses that are funded and run primarily by their owners. Investors in actively run businesses who want limited liability status for all owners generally benefit by forming an LLC or a corporation: Both of these entities permit investors to help run the business while enjoying the personal protection of limited liability.

S Corporations

Now we come to our last comparison, and the one with the pickiest technical distinctions: the S corporation versus the LLC. Below, we address the main similarities and differences, but you may need to ask your tax adviser for further particulars if you want to understand the ins and outs of comparing these two business forms.

For starters, an S corporation follows the same state incorporation formalities as a C corporation. Typically, this means filing articles of incorporation and paying a state filing fee. An S corporation also must make a special one-page tax election under Subchapter S of the Internal Revenue Code to have the corporation taxed as a partnership (by filing IRS Form 2553, *Election by a Small Business Corporation*, with the IRS).

Number of S Corporation Owners

Generally, an S corporation may have no more than 100 shareholders (who must be individuals or certain types of trusts or estates). But spouses and other members of a shareholder's family who own shares in an S corporation are counted as one shareholder.

Limited Liability of S Corporation Shareholders

All S corporation shareholders are granted personal protection from the debts and other liabilities of the business, just like C corporation shareholders and LLC members.

Tax Election of S Corporation

S corporations benefit from the same basic pass-through treatment afforded partnerships and LLCs, so profits and losses are reported on the individual tax returns of the S corporation's shareholders. However, the S corporation must still prepare and file an S corporation annual income tax return each year, similar (from a time and energy standpoint) to the co-owned LLC preparing its own partnership informational tax return.

S Corporations Compared to LLCs

Like any other type of corporation, an S corporation requires some legal care and maintenance—more than is typically needed for an LLC. Regular and special meetings of directors and shareholders are held and recorded to transact important corporate business or decide key legal or tax formalities.

The main difference between S corporations and LLCs has to do with the requirements for electing S corporation tax treatment and some of the unique tax effects that result from this election. To be eligible to make an S corporation tax election with the IRS, the

corporation and its shareholders must meet a number of special requirements. Here are a few of the S corporation tax requirements that can present a problem:

- **Individual shareholders of an S corporation must be U.S. citizens or have U.S. residency status.** If shares are sold, passed to (by will, divorce, or other means), or otherwise fall into the hands of a foreign national, the corporation loses its S corporation tax status.
- **Shareholders must be individuals or certain types of qualified trusts or estates.** Generally, S corporations can't have partnerships or other corporations as shareholders. Under typical state statutes, LLCs may have both natural (individual) and artificial (corporate, LLC, partnership, trust, and estate) members.
- **There can be no more than 100 shareholders in an S corporation.**
- **S corporations must have only one class of stock.** Different voting rights are permitted, meaning that S corporations may have one class of voting shares and another consisting of nonvoting shares. But all shares must have the same rights to participate in dividends and the assets of the corporation when the business is sold or liquidated. Having only one class of stock limits the usefulness of the S corporation as an investment vehicle. Investors typically like to receive special classes of shares that have preferences regarding corporate dividends and participation in the liquidation assets of the corporation when it is sold or dissolved.
- **An S corporation that loses its status cannot reelect it for five years.** An S corporation can lose its S corporation tax status—perhaps inadvertently; for example, if some shares fall into the hands of a disqualified shareholder. Even if the corporation again

becomes qualified, it must wait until five years have elapsed from the year of the disqualification.

Two special tax effects not suffered by other pass-through tax entities, such as LLCs and limited partnerships, often present problems for S corporation shareholders:

- **S corporation shareholders can't receive special allocations of profits and losses.**

Corporate profits and losses must be split up proportionately to the percentage of shares owned by each shareholder. This point may sound technical or theoretical, but even for smaller businesses it has practical—and sometimes negative—significance.

EXAMPLE:

Ted and Natalie want to go into business designing solar-powered hot tubs. Ted is the “money” person and agrees to pitch in 80% of the first-year funds necessary to get the business going. Natalie is the hot tub and solar specialist and will contribute her skills as a solar systems and hot tub designer in overseeing the design and manufacture of the tubs. Ted and Natalie want a portion of Natalie's first-year salary to go toward paying for her initial shares in the enterprise. They also want Ted to get a disproportionate number of shares in recognition of the extra risk associated with putting cash into the business up front. Instead of getting two shares for every one of Natalie's shares, which reflects the ratio of Ted's cash to the value of Natalie's services, they want him to receive four shares for every share that she gets. Unfortunately, while this disproportionate doling out of shares may make a lot of practical sense, it is not permitted under S corporation rules.

- **S corporation entity-level debt can't be passed along to shareholders.** An S corporation generally can't pass the potential tax benefits of borrowing money along to its shareholders. In other pass-through entities, such as partnerships and LLCs, business debt (money borrowed by the business) increases the tax basis of the owners (we're simplifying here, but this is the effect of these special rules). This is good for a couple of reasons. First, the owners can deduct more losses from the business on their tax returns. Second, the higher the basis, the less gain—and the lower the taxes due—when owners sell their interests or the business itself is sold. This technical tax point is illustrated in the following example.

EXAMPLE:

Mitch's Barbecue Pit Corp., organized as an S corporation, is a promising business in search of outside capital for expansion. A special blend of seasonings in Mitch's secret rib sauce consistently brings in overflow crowds to his two downtown locations. A number of people have expressed interest in investing in Mitch's expansion into other cities. It's expected that the venture will generate business losses in its first years immediately following the capital infusion. Mitch's will borrow funds from banks to supplement cash reserves and working capital. At first, interested investors plan to simply use the early S corporation losses to offset other income on their personal tax returns. However, the investors' tax advisers warn that because S corporation debt cannot be used to increase the tax basis of the shares held by the investors (as it could in a partnership or LLC) investors won't get to write off all the expected business losses on their

New Types of LLCs on the Legal and Tax Horizon

Here are the latest LLC variations.

Series LLC. The series LLC allows members to own interests in different series of assets and different revenue streams of the LLC. A number of states (the list keeps growing) allow for the formation of a series LLC. The main characteristic and advantage of the series LLC is that it allows the LLC to set up one or more series of assets within the LLC. Each series is administratively separate from the other series, which means that separate businesses and properties can be subsumed into one LLC entity, but the business and assets of each series can be managed and operated separately from the business and assets of other series. For example, each series can have separate owners and managers, a separate operating agreement that specifies a separate division of profits and losses associated with the series, and other separate formation and operation characteristics. An important aspect of some series LLC statutes is that each series is insulated from liabilities of other series within the LLC. A series LLC can work well to insulate multiple real property parcels owned by a real property developer. It may also work for an LLC engaged in separate lines of business that have unique legal liabilities attached to each business. Generally, however, it is unnecessarily costly and complex to form a series LLC to operate a locally owned and operated business.

The L3C. This is an acronym for the “low-profit limited liability company,” an entity allowed under the statutes of a growing number of states. An L3C is organized to perform services

or engage in activities that benefit the public.

The L3C statutes allow the L3C to make a profit as a secondary purpose. The idea behind this entity is to allow public-spirited LLCs to receive seed money from large nonprofit foundations. However, because L3Cs are not automatically qualified as tax-exempt nonprofit organizations under federal and state tax laws and because they may not be eligible to receive foundation funds without the addition of significant restrictions to their articles and operating agreement, they face challenges finding credibility in the real world of nonprofit-foundation funding.

Nonprofit LLCs. Some larger tax-exempt nonprofit organizations segregate nonprofit funds or assets in a nonprofit LLC that is owned by the parent nonprofit organization. The assets of the nonprofit LLC must be irrevocably dedicated to nonprofit purposes, and the LLC cannot pay out profits to its members. As another strategy, larger nonprofits may form a regular profit-making LLC to place a limited liability shield around one or more of the nonprofit’s unrelated business activities. As long as the LLC’s income and activities are insignificant relative to the overall income and activities of the parent nonprofit, this arrangement may pass muster with the IRS. Note that the parent nonprofit must pay income tax on profits passed through to the nonprofit by its LLC subsidiary.

Each of the above LLC entities is unique and limited in scope and purpose. You should get the help of a lawyer and a tax specialist if you are interested in forming one of them.

individual tax returns. This technical tax disadvantage of the S corporation ultimately results in Mitch's having difficulty finding investors to fund its planned business expansion.

We won't go into this technical point further. Just realize that an S corporation has less flexibility than other pass-through entities to use borrowed money of the business to increase the tax benefits to the owners on their annual individual tax returns and lower the tax bite when the business or their interests in it are ultimately sold. Your tax adviser can fill you in on the details if you want more information.

Electing S Corporation Tax Status May Cut Your Self-Employment Tax Bill

There is still a potential advantage of the S corporation over the LLC under current self-employment tax rules. Specifically, profits of the S corporation, which automatically pass through to the shareholders, are not subject to the self-employment (Social Security and Medicare) taxes. In an LLC taxed as a pass-through entity whose members are active in the business, the members pay self-employment taxes on all LLC profits allocated to them each year. And, presumably, if an LLC elects corporate tax treatment, the LLC pays its share (half) of the self-employment tax on profits paid to members as salaries, with the members picking up the tab on the other half. For further information on the current Social Security tax rules that apply to LLCs, see Chapter 3.

To summarize, even if S corporation status makes sense to gain the benefits of limited liability for the owners but keep the pass-through tax status for business income and losses (and maybe save on self-employment taxes as mentioned above), it is often inconvenient or uncertain because of the requirements for adopting and keeping S corporation tax eligibility. By comparison, the tax status of an LLC is sustained and certain throughout the life of the business. Further, the above technical tax considerations make the S corporation less attractive to investors seeking to maximize the deductions and losses they can pass through the business and claim on their individual tax returns.

Business Entity Comparison Tables

In the tables below, we highlight and compare general and specific legal and tax traits of each type of business entity. We include a few technical issues in our chart (partially covered above). Should any of the additional points of comparison seem relevant to your particular business operation, we encourage you to talk them over with a legal or tax professional.

Business Entity Comparison Chart—Legal Characteristics						
	Sole Proprietorship	General Partnership	Limited Partnership	C Corporation	S Corporation	LLC
Who owns business?	sole proprietor	general partners	general and limited partners	shareholders	same as C corporation	members
Personal liability for business debts	sole proprietor personally liable	general partners personally liable	only general partner(s) personally liable	no personal liability of shareholders	same as C corporation	no personal liability of members
Restrictions on kind of business	may engage in any lawful business	may engage in any lawful business	same as general partnership	some states prohibit formation of banking, insurance, and other special businesses	same as C corporation—but excessive passive income (such as from rents, royalties, interest) can jeopardize tax status if corporation converted from C to S corporation	same as C corporation, and some states may prohibit the performance of professional services
Restrictions on number of owners	only one sole proprietor	minimum two general partners	minimum one general partner and one limited partner	most states allow one-person corporations; some require two individuals to serve as officers	same as C corporation, but no more than 100 shareholders permitted	one member allowed in all states
Who makes management decisions?	sole proprietor	general partners	general partner(s) only (not limited partners)	board of directors	same as C corporation	ordinarily members; or managers if manager-managed LLC
Who may legally obligate business?	sole proprietor	any general partner	any general partner (not limited partners)	directors and officers	same as C corporation	ordinarily any member; or any manager if manager-managed LLC
Effect on business if an owner dies or departs	dissolves automatically	dissolves automatically unless otherwise stated in partnership agreement	same as general partnership	no effect, unless corporation is solely owned	same as C corporation	in a small number of states, dissolves unless remaining members vote to continue business
Limits on transfer of ownership interests	free transferability	consent of all general partners usually required under partnership agreement	same as general partnership	transfer of stock may be limited under securities laws or restrictions in articles of incorporation or bylaws	same as C corporation—but transfers limited to persons and entities that qualify as S corporation shareholders	unanimous consent of nontransferring members may be required under state law or operating agreement
Amount of organizational paperwork and ongoing legal formalities	minimal	minimal; partnership agreement recommended	start-up filing required; partnership agreement recommended	start-up filing required; bylaws recommended; annual meetings required	same as C corporation	start-up filing required; operating agreement recommended; meetings not normally required

Business Entity Comparison Chart—Legal Characteristics (cont'd)						
	Sole Proprietorship	General Partnership	Limited Partnership	C Corporation	S Corporation	LLC
Source of start-up funds	sole proprietor	general partners	general and limited partners	initial shareholders (in some states, cannot buy shares with a promise to perform services or contribute cash in the future)	same as C corporation—but cannot issue different classes of stock with different financial provisions	members (may usually invest with promise to perform services or contribute cash in the future)
How business usually obtains capital, if needed	sole proprietor's contributions; working capital loans backed by personal assets of sole proprietor	capital contributions from general partners; business loans from banks backed by partnership and personal assets	investment capital from limited partners; bank loans backed by general partners' personal assets	flexible; outside investors may buy various classes of shares; bank loans backed by shareholders' personal assets (if corporation has insufficient credit history); may go public if need substantial infusion of cash	generally same as C corporation—but can't have foreign, partnership, or corporate shareholders; must limit number of shareholders to 100; can't offer different classes of stock to investors except for shares with different voting rights	capital contributions from members; bank loans backed by members; personal assets (if LLC has insufficient credit history)
Ease of conversion to another business form	may change form at will; legal paperwork involved	may change to limited partnership, corporation, or LLC; legal paperwork involved	may change to corporation or LLC; legal paperwork involved	may change to S corporation by filing simple tax election; change to LLC can involve tax cost and legal complexity	generally same as C corporation—may terminate S tax status to become C corporation but cannot reelect S status for five years after	may change to general or limited partnership or corporation; legal paperwork involved
Is establishment or sale of ownership interests subject to federal and states securities laws?	generally not	generally not	yes, issuance or sale of limited partnership interests must qualify for securities laws exemption, otherwise must register with federal and state securities laws offices	yes, issuance or transfer of stock subject to state and federal securities laws or must qualify for securities laws exemptions	same as C corporation	probably not, if all members are active in business
Who generally finds this the best way to do business?	owner who wants legal and managerial autonomy and minimal organizational red tape	joint owners who are not concerned with personal liability for business debts	joint owners who want partnership tax treatment and some nonmanaging investors; general partners must be willing to assume personal liability for business debts	owners who want limited liability and ability to split income between themselves and a separately taxed business	owners who want limited liability and individual tax rates to apply to business income; must be willing to meet initial and ongoing S corporation requirements	generally, owners who want limited liability and pass-through taxation; particularly beneficial for smaller, privately held businesses

Business Entity Comparison Chart—Tax Characteristics						
	Sole Proprietorship	General Partnership	Limited Partnership	C Corporation	S Corporation	LLC
How business profits are taxed	individual tax rates of sole proprietor	individual tax rates of general partners, unless business elects corporate treatment	individual tax rates of general and limited partners, unless business elects corporate tax treatment	split up and taxed at corporate rates and individual tax rates of shareholders	individual tax rates of shareholders	individual tax rates of members
Tax-deductible fringe benefits available to owners who work in business	sole proprietor may set up IRA or Keogh retirement plan	general partners and other employees may set up IRA or Keogh plans	same as general partnership	tax-deductible fringe benefits for employee-shareholders; can reimburse employees' medical expenses and provide tax-free term life insurance; can set up stock equity plans for employees	same as general partnership, but employee-shareholders owning 2% or more of stock are restricted from receiving deductible corporate fringe benefits; equity-sharing plans generally not available	owners get tax benefits associated with sole proprietorship (one-member LLCs) or partnership (multi-member LLCs)
Automatic tax status	yes	yes	yes, upon filing certificate of limited partnership with state corporate filing office	yes, upon filing articles of incorporation with state corporate filing office	no; must meet requirement and file tax election form with IRS (and sometimes state); revoked or terminated tax status cannot be re-elected for five years	yes, one-member LLC treated as sole proprietorship; multi-member LLC treated as partnership
Are taxes due when business is formed?	generally tax free to set up	generally tax free to set up; individual income taxes may be due if a general partner contributes services as capital contribution	usually same as general partnership	generally not taxable if under IRC Section 351	same as C corporation	generally tax free to set up; individual income taxes may be due if a member contributes services as capital contribution
Deductibility of business losses	owner may use losses to deduct against other income on individual tax returns (subject to passive loss rules that apply to all businesses)	partners may use losses to deduct other income on individual tax returns if "at risk" for loss or debt and subject to active-passive loss rules	same as general partnership, but limited partners may only deduct "nonrecourse debts" (for which general partners are not specifically liable)	corporation may deduct business losses (shareholders may not deduct losses)	shareholders may deduct share of corporate losses on individual tax returns, but must comply with passive loss limitation; shareholders normally do not get the tax benefit of entity-level debt	follows sole proprietorship or partnership rules depending on tax status of LLC
Tax level when business is sold	personal tax level of owner	personal tax level of individual general partners	personal tax level of individual general and limited partners	two levels: shareholders and corporation may be taxed on sale of business	normally taxed at personal tax levels of individual shareholders, but corporate level tax sometimes due if S corporation was formerly a C corporation	follows sole proprietorship or partnership rules depending on tax status of LLC

Basic LLC Legalities

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This chapter examines basic legal issues and procedures involved in setting up and running an LLC. We'll explain the paperwork, operating structure, and liability rules for new LLCs. With this information, you can decide how you want your LLC to be set up and managed. In later chapters, we'll help you draft and file your articles of incorporation and create an operating agreement.

Number of Members

You can have as many LLC members as you want, although we think that more than 35 is unwieldy. You can have only one member if you want. You indicate the ownership percentage of each member in your operating agreement, discussed in Chapters 5 and 6.

Paperwork Required to Set Up an LLC

Let's look at the basic legal documents and procedures involved with starting your own LLC. Fortunately, it's a simple process, meaning that it should take you relatively little time to turn your idea of forming an LLC into a legal reality.



TIP

One person may prepare and file the paperwork. Generally, one person may prepare, sign, and file the basic documents to set up an LLC. This person need not be a member of the LLC, but must turn the reins of management over to LLC members or a management team after the LLC is formed. The purpose of this law is to allow a lawyer to do the filing for you—which is fine if that's what you want. Normally, you can just as well prepare the paperwork yourself and drop it in the nearest mailbox. Even though one person can set up an LLC by filling in

routine LLC paperwork, it is crucial that all LLC members agree on important information reflected in your articles of organization and operating agreement (see Chapters 4 through 6 for instructions on preparing these documents). For example, if your LLC has other members, you will want to reach agreement on whether your LLC will be member- or manager-managed before preparing and filing your articles (LLC articles normally contain a statement specifying how the LLC will be managed).

Form Your LLC Using Nolo's Online Service or Software

Nolo's online LLC formation service helps you form your LLC directly on the Internet. Once you complete a comprehensive interview online, Nolo will create your articles of organization and file them with the state filing office, prepare a customized operating agreement, and assemble other essential legal forms for your LLC.

The LLC online service is available at www.nolo.com.

LLC Articles of Organization

The only formal legal step normally required to create an LLC is to prepare and file LLC articles of organization with your state's LLC filing office. A few states require an additional step: the publication in a local newspaper of a simple notice of intention to form an LLC prior to filing your articles.

The LLC filing office is usually the same one that handles your state's corporate filings, typically the Department or Secretary of State's office, located in the state capital. Larger states usually have branch filing offices in secondary cities as well. See Appendix A to locate your state's LLC filing office online.

LLC articles of organization normally are not lengthy or complex. In fact, you can usually prepare your state's form in just a few minutes by filling in the blanks and checking the boxes on a relatively simple form. Typically, you need only specify a few basic details about your LLC, such as its name, principal office address, agent and office for receiving legal papers, and the names of its initial members (or managers, if you're designating a special management team to run the LLC).



RESOURCE

Instructions for completing articles of organization. We provide a sample LLC articles of organization form with instructions and show you how to get your state's form to fill in and file, in Chapter 4.

LLC Operating Agreement

An LLC should always create a written operating agreement to define the basic rights and responsibilities of LLC members (and managers, if you decide to form a manager-run LLC—more on this option later). Without a written agreement to refer to, you may get stuck in a crisis trying to answer such questions as:

- When members are faced with an important management decision, does each get one vote, or do they vote according to their percentage interests in the LLC?
- Are owners expected to make additional capital contributions (meaning invest more money) if the LLC needs additional operating capital?
- Are owners entitled to periodic draws from the profits of the business?
- Will interest be paid to the owners on their capital contributions?
- May members leave the LLC any time they wish and expect an immediate payout of their capital contributions?

- How much should an owner be paid when he or she decides to leave the business?
- Is a departing owner allowed to sell an interest to an outsider?

Please believe us when we say that these kinds of unanswered questions can, and frequently do, come back to haunt small businesses. They are far better addressed in a written operating agreement, signed around the time your new LLC entity is created. And if you don't create your own operating agreement, your state's LLC default rules (which you may not necessarily agree with) may come into play (see “LLC Lacking Operating Agreement Is Controlled by State LLC Statutes,” below).



RESOURCE

Instructions for completing LLC operating agreements. Chapters 5 and 6 provide instructions for completing the two different types of operating agreements included in Appendix B.

Responsibility for Managing an LLC

At least one person needs to be responsible for overall management of a business, and the LLC is no exception. Under most states' default legal rules, all members (owners) are automatically responsible for managing the business (this arrangement is called “member-management”), unless they specifically appoint one or more members and/or nonmembers to manage the LLC (this option is called “manager-management”).

Member-Managed or Manager-Managed LLC?

Most LLC owners will choose member-management, not manager-management. That's because most smaller LLCs won't want an extra

level of bureaucracy; they'll want to let the LLC members run the business they own. Unless you are planning to bring in outside investors who want a management role in your business, it's likely that you'll naturally decide to be member-managed.

Manager Options

If you wish to elect a special management team for your LLC, you'll have to select a group of managers. These are the options when selecting managers in a manager-managed LLC:

- **Select members as managers.** Some larger LLCs—for example, those with passive investors who will not work in the business—may decide to name only active members as managers.
- **Select only nonmembers.** Some LLCs decide that management should consist exclusively of nonmembers with particular expertise in the business of the LLC (by hiring an outside consultant or an LLC officer as manager).
- **Select some or all LLC members, plus nonmembers as managers.** Still other LLCs may settle for a combination of members, investors, and nonmember managers.

Tax Consequences

The non-managing members of a manager-managed LLC may be able to avoid paying self-employment tax on their share of LLC profits. We'll discuss this further in Chapter 3.

Securities Law Consequences

We cover the securities law implications of LLC management choices later in this chapter. For now, just realize that if one or more of your members does not participate in management, membership interests in your LLC may be considered securities, and you may need to

comply with extra federal and state securities procedures when setting up your LLC.

LLC Lacking Operating Agreement Is Controlled by State LLC Statutes

If you run your LLC without an operating agreement, your state's LLC statutes will control basic elements of how your LLC is run and terminated. These statutes may not reflect the choices you want to make for your LLC. For example, typical state statutes specify that an LLC is managed by the members (owners). In addition, some states establish that profits and losses are to be divided up among the members equally (per capita), regardless of each member's capital contribution.

EXAMPLE:

Yvonne and Joe form an LLC with Yvonne contributing 30% of the capital to get started and Joe contributing 70%. Under their state's default rule, Yvonne and Joe each would be entitled to receive one-half the profits of the LLC each year, even though they pay disproportionate amounts to get the LLC up and running. If Yvonne and Joe prepare their own operating agreement, however, they can divide profits according to their capital contributions, if they wish.

Selection and Removal of Members and Managers

Initial members or managers of the LLC are usually named in the articles of organization filed with the state LLC filing office. According to the default rule in many states, which operates unless your operating agreement says something else, new members can be admitted only by the vote of all members of the LLC. If

Nonvoting vs. Nonmanaging Members

LLC members have special voting rights under state law, which include voting to amend the articles or operating agreement, to merge or dissolve the LLC, to approve the admission of new members, and to approve the transfer of a membership by an existing member to an outsider. In addition, in manager-managed LLCs, members have a right to vote to elect or reelection the managers (even though some members may also be managers and can vote to reelection themselves).

Many of these voting rights can be eliminated or restricted in LLC articles or an operating agreement by giving the member no voting power in the LLC operating agreement. Even here, though, some states require the vote, and sometimes approval, of all or a majority of members to certain major structural changes to the LLC, such as amending the articles or operating agreement or dissolving the LLC, no matter what your operating agreement says. This issue of membership voting power leads to the following question: Is eliminating the voting power of a member the same thing as making the member a non-managing member? The answer, in our view, is no. State LLC statutes, for the most part, treat members' voting rights as separate from members' management responsibilities and make all LLC members of a member-managed LLC responsible for managing the LLC without

reference to specific voting rights of the member. For example, state law typically says that all members of a member-managed LLC are charged with managing it in good faith and can act as "agents" of the LLC by binding it to a contract or business deal with outsiders.

Another way to look at this issue is to think of members as you would of the shareholders (owners) of a corporation. Shareholders can be given voting or nonvoting shares in a corporation, but the people responsible for management of a corporation are the board of directors, regardless of the types of shares (voting or nonvoting) held by the owners. Unless you select a separate management team for your LLC—by choosing a manager-management structure—state law pretty much treats your members as the "board of directors" of your LLC, each of whom is responsible for its management (without considering whether these LLC members also have specific voting rights under state law or your operating agreement). Finally, one of the primary voting rights of a member in a manager-managed LLC is the right to vote for the election or reelection of the managers—clearly, state law intends to make membership voting rights separate from management power, just as in the corporate context where voting shareholders get to vote for the election of the board of directors.

your LLC has chosen manager-management, the default rule is that anyone selected to replace an initial manager must be voted in by a majority of the members. But you can vary this latter rule in your operating agreement to let the managers (by a majority or greater vote), rather than the members, vote to fill a manager vacancy.

State law is usually silent on the issue of how and why members or managers of an LLC may be removed. Under typical provisions found in LLC operating agreements, members cannot be removed from the LLC member roster except for specific reasons, such as bankruptcy, incapacity, or another listed reason, and then only with the vote of all other members.

Manager removal is usually easier under most operating agreements and often is allowed “without cause” (for any or no particular reason) upon a vote of the membership. Managers are also typically elected by the members to specific terms of office—in other words, they can be voted out of office at the expiration of their management term if the members elect someone else in their place.

Legal Authority of LLC Members and Managers

Generally, the members (if member-managed) or managers (if manager-managed), or other duly appointed representative (such as an officer) of the LLC can legally bind the LLC to a contract, business transaction, or course of action, as long as the transaction is within the LLC’s normal scope of business. A common legal exception states that a contract with an outsider who knows, or should have known, that the LLC agent does not have specific authority for a transaction is not binding on the LLC. Unfortunately, this type of knowledge is hard to prove.

EXAMPLE:

Gary is a member and VP of Fish and Fritters Fast Foods, LLC (“4F”)—a member-managed LLC. He orders \$500 in stationery from Joe’s Stationery Supply Company, a local merchant, consisting of \$400 of 4F stationery and \$100 of personal letterhead. When he places the order, he does so on behalf of 4F, and charges the bill to 4F’s account. Joe gets a check from 4F for \$400, with a note from the accounts payable officer advising Joe to collect the \$100 balance from Gary because the order for personal letterhead was not approved by 4F. Would a small claims court let Joe recover the \$100 balance from 4F? Probably. Joe would normally be justified in believing that an officer of 4F had authority to place the full order on its behalf, unless Gary specifically told Joe that the extra stationery should be billed to him alone.

It’s safest to assume that any contract or transaction signed on behalf of your LLC by anyone in management will be legally binding. This legal authority should not present a problem if you choose the right people to be members or managers of your LLC.



CAUTION

If you’re uncomfortable with others obligating your business, a co-owned LLC is probably not the right business entity for you. You may want to stick to a sole proprietorship (or to a single-member LLC), where you have the only say, or to a limited partnership, where you can get full management authority if you are the only general partner.

Member and Manager Voting Rules

The default laws of many states (those that apply unless your operating agreement says otherwise) specify that members' voting rights are allocated according to the capital contributions made by each member. In other words, a member contributing 50% of the capital usually gets 50% of the voting power. But in some states, the default voting right rule is that members are given voting rights on a per capita basis (one vote per member) if the LLC operating agreement doesn't set a different standard. And other states use members' interests in LLC *profits*, which may be different from capital interests, as the default measure of member voting rights.

Under state default rules, most LLC matters brought to a vote of the members must be approved by at least a majority of the LLC's voting power—that is, by more than 50% of the full voting interests of the members.

EXAMPLE:

Sit-u-ational Awareness, LLC, a three-member computer furniture ergonomics consulting firm, has parceled out its voting interests to the three owners as follows: Kathryn—30%, Evan—25%, and Alyson—45%. The vote of at least two of the three members is necessary to obtain a majority and decide an issue brought to the membership for resolution.

If the LLC is manager-managed, states typically give managers one vote each, with a majority manager vote required to approve a decision.

EXAMPLE:

Dollars to Donuts, LLC, is owned by four entrepreneurs but managed by a team of five persons consisting of the four members

and a nonmember pastry chef, Pierre (who brings the recipe for a delectable French twist pastry—the hallmark of the enterprise—to the business, plus his formidable baking skills). When an important management vote needs to be made, each manager gets one vote, and the vote of at least three of the five managers is required to resolve the matter. Pierre doesn't function as a fifth wheel on the management team—he becomes the all-important deadlock-breaking vote whenever the four owners don't see eye to eye and split their votes two-to-two.

Remember, as with most state law rules mentioned in this chapter, these are default member and manager voting rules. You can override them by defining voting rights any way you wish in your operating agreement.



CAUTION

Nonvoting members may sometimes get a vote. You can have one or more nonvoting members—just specify in your operating agreement that the nonvoting member has zero votes. Realize, however, that even if you give a member zero votes, the nonvoting member may be given some voting power in special situations under your state's LLC laws. For example, it is common for state law to require the votes, if not approval, of all LLC members to amend the LLC articles of organization or operating agreement, to dissolve the LLC, or in other significant legal matters involving changes to the structure of the LLC.

Membership and Management Meetings

Most states do not give mandatory rules for when and how membership meetings should take place. It's ordinarily up to you to come up with your own rules for the frequency, notification procedures, and conduct of membership meetings.

Regular LLC meetings are not required in the operating agreements in this book (although you can require meetings if you're so inclined), because you don't need to hold formal meetings to make many of the important decisions that keep your business operating smoothly. These meetings can be time-consuming, and if they aren't necessary, time may be better spent on the business itself.

Ordinarily, you should hold formal LLC meetings (which are recorded in written minutes) only in situations such as these:

- An important legal or tax formality needs to be approved and recorded (the LLC is undertaking a legal or tax election that should be documented in your LLC records, such as approving the buy-back of a departing member's interest in the LLC).
- You need to meet face-to-face with your full membership and formally approve an out-of-the-ordinary or disputed business decision (sell important LLC assets or dissolve the LLC contrary to the wishes of some of the members).
- You have elected a management team (set up a manager-managed LLC) and need to reelect them to another term (more on this just below).



TIP

You may be required to hold a membership meeting to elect managers if your LLC is manager-managed. States typically say that members must elect the managers at a membership meeting, without specifying terms of office for managers or how often members should meet to elect or reelect managers. However, some states do limit the term for managers to one year unless you override it in your operating agreement. If your LLC is manager-managed and you adopt a one-year term for your managers, you will want to hold annual membership meetings to reelect your managers.

The appointment of managers is a routine task for most LLCs unless a manager is withdrawing or is not performing satisfactorily.



RESOURCE

For forms and instructions for holding LLC meetings and taking care of ongoing LLC business, see *Your Limited Liability Company: An Operating Manual*, by Anthony Mancuso (Nolo).

Member and Manager Liability to Insiders and Outsiders

One of the nicest parts of forming an LLC is the general immunity from personal liability the members and managers enjoy. But it's important to realize that this immunity has its limits. There are some situations in which a person acting as an LLC member or manager may end up liable to the LLC, other members or managers, or outsiders. There are also situations when "outside" liability of an LLC member can impact the LLC and the other members. We discuss these exceptions below.

LLC Members and Managers Must Act in Good Faith Toward Each Other

Members of a member-managed LLC and managers of a manager-managed LLC have a legal obligation in managing the LLC to act in good faith, in the best interests of the LLC and its members. In legal jargon, this duty is known as their "duty of care." It is similar to the obligation corporate directors have to a corporation.

Courts have interpreted this duty in the corporate context by promulgating the "business judgment rule." This rule says that in making management decisions, honest

business mistakes will not subject managers and members to personal liability. Another way of saying this is that decisions that have some rational basis—based upon facts known to managers and members or presented to them in a report from someone else with superior knowledge—should not give rise to personal liability if they turn out to be wrong-headed and result in financial loss to other members or to the LLC.

EXAMPLE:

Bob and Juliet are two of three owners of the Lucky Lock Company LLC—a member-managed LLC. They vote at a management meeting to use one-quarter of the company’s accumulated earnings to market and sell Bob’s Big-Lock, a unique lock plate with a neon clock display that Bob invented. Greg, the third owner at the meeting, is against the idea of committing company funds to promote a device with such an uncertain future. The uncertainty of the profitability of Bob’s Big-Lock is fully discussed at the membership meeting, but Greg is outvoted two-to-one by his co-owners. The clock-lock idea doesn’t catch on, and the project loses money big time. Can Greg sue the other owners personally for their bad business judgment? As long as Bob and Juliet made a bad business decision without underhandedness, concealment, or misrepresentation of facts or other fraud or illegality, the answer should be “no” under the business judgment rule.

But let’s say Bob and Juliet knew that certain features of the purported master timepiece would be difficult to produce, yet kept this knowledge from Greg when they pitched Bob’s Big-Lock idea. Greg may be able to recover some or all of the clock-loss money personally from Bob and Juliet for

failing to disclose all material facts at the management meeting.

The above example points out a basic LLC legal rule: Full and fair disclosure of facts is part and parcel of an LLC member/manager’s duty to the LLC—a duty that isn’t mitigated or otherwise lessened by the business judgment rule.

Liability to Other Members for Unjustifiable Loss

Most states have provisions in their LLC laws that permit members to sue other members or managers on behalf of (in the name of) the LLC. Often called “derivative actions” in legal lingo, these lawsuits can occur if a member feels that other members or managers caused unjustifiable financial loss to the LLC.

EXAMPLE:

Let’s use the same Lucky Lock Company LLC described above. This time, members Bob and Juliet siphon off some of the funds for themselves, personally, rather than using them to prototype and sell Bob’s Big-Lock. Bob and Juliet can expect to be sued by and be held personally liable to the LLC and/or to Greg for the amount of the diverted funds.

Many states have “indemnification” provisions in their LLC laws. This fancy legal word means that the LLC will pay the legal expenses, settlements, court judgment awards, fines, fees, and other liabilities personally assessed or awarded against an LLC member or manager for ill-advised management decisions or other liability-causing events. Generally, state rules say that the person to be indemnified must have acted in good faith, in the best interests of the LLC, before he or she can be reimbursed or advanced legal expenses or receive other

indemnification. And, as you might guess, intentional misconduct, fraud, and illegal acts normally can't be covered under these statutes. Indemnification provisions vary and are technical, so check with an LLC legal adviser or take a closer look at your state's LLC indemnification statute if this area of LLC law interests you.

Liability to Outsiders

No matter how an LLC is managed—whether by LLC members or a management team—one basic limited liability rule applies. LLC members and managers are not normally personally responsible to outsiders for any mistakes in management that they make.

EXAMPLE:

A customer of Jen & Len's Computers LLC sues the company, as well as each owner personally, for not fixing a problem with his two-gigabyte hard drive, resulting in 40 hours of extra work to get the data back online. Are Jen and Len personally liable to the customer? No. Limited liability should protect them.

What about torts (the legal term for an act that harms another person and causes monetary loss—for example, running a red light and causing an accident that damages another automobile)? Members of an LLC, like corporate directors, partners, and all other business managers, can be personally liable for financial loss caused by their negligent tortious behavior. Whether working for an LLC as an employee or acting in the capacity of a member, if a member does something negligently that causes harm to another person or that person's property, the member can be held personally liable for the damage.

EXAMPLE:

Otto, one of the two employee/members of Otto's Auto Parts Supply LLC, gets in his Mazda Miata to pick up a throwout bearing for a customer's Mercedes station wagon. On the way, he sideswipes a slow-moving Geo, a stunt that results in a \$5,000 repair bill to the Geo owner and a \$25,000 medical claim for whiplash to George, the Geo driver. Otto can be held personally liable for \$30,000.

Of course, insurance—commercial, automotive, workers' compensation, or even the employee's individual homeowner policy—may cover some or all damage caused by LLC manager or worker torts. Check LLC and personal insurance policies to see what protection may be available to you in the event of an accident.

LLC Exposure to Personal Claims—The Flip Side of Limited Liability

The discussions above cover several exceptions to the standard rule that the LLC protects the members from creditor claims against the LLC. Let's turn the tables: Can a creditor of an LLC owner seize the owner's membership interest in an LLC? The answer is “yes” under the laws of most states. Because an interest in an LLC is the personal property of each LLC owner, state law normally allows a creditor of an individual to obtain a charging order against that individual's interest in a business, such as a partnership or LLC interest or a person's stockholdings in a corporation. Essentially, a charging order acts as a lien against the business interest, allowing the creditor to receive the payments of profits that would otherwise go to the owner of the interest.

EXAMPLE:

Sam defaults on a personal bank loan, and the bank obtains a charging order against

LLCs Should Have Liability Insurance Coverage

Our advice is to get reliable liability insurance to cover potential personal and business liabilities arising from the LLC's operations. Typically, a commercial general liability insurance policy will cover:

- tort liability (bodily injury and property damage, so-called "slip-and-fall" coverage) caused by business owners and employees in the course of business or on the business premises, and
- fire, theft, catastrophe, and the like.

Most smaller LLCs, at least to begin with, rely primarily on their commercial liability insurance to protect them in the event of lawsuits brought by outsiders. They may go beyond this basic coverage later if they can afford to supplement it with personal liability policies for members or other managers. Such policies can protect members and managers from personal liability for torts to outsiders as well as inside liability to the LLC for losses caused by members' or managers' faulty decisions.

Make sure you look for newer policies that recognize the legal status of your LLC and its members. Because LLCs are relatively new, insurance companies may need to adapt their current corporate director and officer "errors and omissions" policies for use by LLC members and managers.

Sam's LLC membership interest. This order allows the bank to be paid any profits distributed to Sam under the terms of the LLC's operating agreement.

A charging order may not do a creditor much good if an LLC does not regularly distribute

profits to members. In that case, a creditor may ask a state court to foreclose on the LLC's member's interest. If state law allows this foreclosure, and if the court agrees, a personal creditor of an LLC member can become a new legal owner of the LLC.

However, under most state laws, the creditor who forecloses on an LLC interest does not become a full owner. Instead, the law says that the foreclosing creditor becomes a "transferee" or "assignee" who is entitled to all economic rights associated with the interest, including the value of the interest when the business is sold or liquidated. Typically, an assignee or transferee is not allowed to manage or vote in the LLC nor assume other membership rights granted to full members under the LLC operating agreement.

If the LLC does not pay out profits regularly and if there is little likelihood of the business being sold or liquidated, these economic rights may mean very little to a creditor. However, if a creditor can step in as a full voting member when foreclosing on a member's interest, this can have a crippling effect on the operation of the LLC. After all, the creditor's primary interest is liquidating the value of the member's interest to obtain repayment on the delinquent debt or claim, not on signing on as part of a continuing enterprise.

One final downside associated with creditor claims against LLC membership interests is that some state laws allow transferees or assignees of LLC memberships to petition a court to force a dissolution of the LLC. This is an extreme remedy that may be available to creditors who can foreclose on an LLC membership interest in some states.

To determine whether a personal creditor of an LLC member can obtain a charging order, foreclose, or force a dissolution of an LLC, consult an experienced lawyer in your state.

Are LLC Membership Interests Considered Securities?

When someone buys into or invests in an LLC, that person is being sold an interest in the business. Is this sale of an LLC interest the sale of a “security” within the meaning of state or federal law? If it is, it must either be registered at the federal level—with the Securities and Exchange Commission—and with the state securities office, or it must be eligible for an exemption from these federal and state securities registration requirements.

The question of whether and under what circumstances LLC memberships may be a security interest isn’t black and white but we’ll mention a few basic expectations of the securities law treatment of LLCs. A helpful generalization is that when the owner of an interest in a business relies on his or her own efforts to make a profit, the interest normally is not a security interest. Conversely, if a person invests in a business with the expectation of making money from others’ efforts, federal and state statutes as well as the courts usually treat the interest purchased with the investment as a security.

Securities laws are meant to protect investors from unscrupulous operators, not active business owners from the results of their own business decisions.

Member-Managed LLCs and Securities Laws

If you and your co-owners plan to set up a member-managed LLC—where, by definition, all members are legally responsible for its management—it is likely that your membership interests will not be treated as securities. Why? Because all members plan to make a profit in the business from their own efforts, not the efforts of others.

Manager-Managed LLCs and Securities Laws

If you set up a manager-managed LLC, it is likely that the interests of at least the nonmanaging members will be treated as securities under state and federal law. It’s even possible that the feds and the state will treat all membership interests in such an LLC as securities (securities agencies have been known to take an “all or none” position—either all LLC memberships are exempted from the definition of securities or none are).

Don’t give up if your LLC membership interests fall within the definition of “securities.” There are other exemptions from securities that your LLC may qualify for if it is a one-state operation or if it has a limited number of members. Below is a summary of the most commonly relied upon federal securities law exemptions that may apply. Many states either defer to or adopt one or more of these federal exemptions in their securities statutes and regulations. Note that the first two exemptions do not require the filing of any paperwork—you informally rely on them without notification to any securities agency.

- **Private placements.** Under federal statutes and case (court-developed) law, the selling of securities privately—without advertising or promotion—to a limited number of people may be eligible for the private placement exemption contained in Section 4(2) of the federal Securities Act of 1933. You stand a better chance of being eligible for this exemption if transfers of the securities—memberships—are restricted (for example, language restricting transfer of the stock is placed on all membership certificates and a conspicuous notation is made in the LLC membership book that memberships are nontransferable), and if persons buying memberships are doing

so for themselves (that is, not for resale to other investors). Many smaller LLCs will neatly fit within this traditional securities law exemption because memberships are issued to a limited number of people (the number 35 is often used, but not written into this section of law), memberships are a personal investment, and transfer of memberships to outsiders is restricted to satisfy tax requirements (for more on this point, see Chapter 3).

- **Inside-the-state sales.** Another federal exemption, the intrastate offering exemption contained in Section 3(a)(11) of the Securities Act, exempts from registration the offer and sale of securities made within one state only. If you privately offer and sell memberships within one state to residents of that state only, you may qualify for this exemption from federal registration of your memberships.
- **Regulation D.** Getting a Regulation D exemption is a formal process requiring you to follow the Regulation D statutes and file Form D with the Securities and Exchange Commission (SEC). We won't cover the requirements in detail, but offer the following gloss: You stand a good chance of qualifying under Regulation D rules if you privately offer and sell small membership interests to 35 or fewer people (measured in dollar value; the limits vary from \$1 million to \$5 million, but one exemption does not have a monetary limit) each of whom is a close personal friend, family member, or business associate, or has the capability to protect his or her own interests (because of past investment history or current and anticipated net worth and income earning capacity). In addition, you must place restrictions on the transfer of your LLC memberships (language on membership

certificates and in LLC membership records that limits transfers), as explained in the discussion above of the Section 4(2) private placement exemption.

Again, state law securities exemptions tend to parallel one or more of the federal exemptions. For example, a state may exempt from registration the private sale of securities solely within the state or to a limited number of persons, such as 10 or 35. In some states, you may need to file an exemption form, sometimes along with a filing fee.

How Should You Handle Securities Law Issues?

Your decision on how to approach securities law issues will be a personal decision, based upon the particular facts of your LLC formation and your own personal comfort level in this unsettled area of law. For example, if you're setting up a small LLC with your spouse and you plan to actively run the business yourself (say a car repair service, retail outlet, or consulting business), you will very likely decide that you are exempt from securities laws and need not file paperwork. Similarly, if you are setting up your LLC with a handful of owners who know one another and have worked together in the past and who will actively run the LLC, you may likely conclude that you are also on safe legal ground if you do not treat your memberships as securities.

If, however, you bring in outside LLC members who are not active in the day-to-day business of the LLC, or if you bring in outside managers, we strongly recommend making sure your LLC qualifies for exemptions from both federal and state securities laws. You can do your own research in this area, but the securities laws are murky, and the newness of the LLC throws a little extra mud in the water.

**RESOURCE**

Consider hiring a lawyer. To get the latest LLC securities rules in your state, call the state securities board (or similar agency) and ask for a copy of state laws and regulations dealing with the issuance and sale of LLC membership interests. If you don't want to deal with this admittedly complex analysis, call a small business lawyer. Brainstorming with an LLC legal coach to learn the latest legal rules and come up with a safe securities law approach should be well worth the estimated one to three hours' worth of legal fees necessary to put this technical issue to rest. (See "How to Find the Right Lawyer," in Chapter 8, for more information on finding an LLC legal coach.)

The Most Important Securities Law Rule of All: Disclose, Disclose, Disclose!

One important securities law rule always applies to any business venture: Always fully disclose all pertinent facts to potential investors. Let everyone know all known and foreseeable risks of investing in your enterprise, and make all financial records available to prospective purchasers. If you go out of your way to disclose all possible risks of investment, you'll stand a much better chance of fending off securities law problems later if a member or investor starts feeling surly about lower-than-expected profits or returns from the LLC.



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This chapter covers the tax treatment of LLCs. It explains how LLCs are taxed by federal and state governments, as well as special tax considerations when forming an LLC. These and other issues will come up when you prepare your operating agreement (discussed in Chapters 5 and 6). Throughout this book, we let you know when the advice of a tax adviser will be useful (such as when you choose your tax year and accounting method and deal with members' capital contributions to the LLC). Chapter 8 explains how to find and work with a tax adviser and provides more resources on tax and financial information.

Pass-Through Taxation

As explained in Chapter 1, one of the main benefits of forming an LLC is “pass-through” taxation, which allows LLC owners to enjoy the tax advantages of a partnership (or sole proprietorship, for a one-person LLC). Business income is taxed just once, when it is allocated to each member's LLC account (whether or not the income is actually distributed to them). The LLC members pay individual income taxes on these profits. This is different than a corporation: Usually, the corporation pays taxes, and then individual shareholders pay taxes a second time when profits are distributed in the form of dividends. For this reason, LLC owners usually decide that pass-through tax treatment is the best way to go.

But that isn't always the case. Sometimes, it's more advantageous for an LLC to be taxed like a corporation. That's because corporate tax rates are low on relatively low taxable income—15% to 25% on profits (roughly below \$75,000) left in an LLC that elects corporate tax treatment (compared to individual tax rates of up to 35%). Because some LLCs want to keep profits in the business anyway—for example,

to expand or because the profits are tied up in inventory—electing corporate tax treatment can sometimes save money. However, this benefit starts to decrease as profits rise. Profits are taxed at rates of up to 34% on taxable incomes up to \$10 million (with a 39% rate “bubble” on taxable incomes from \$100,001 to \$335,000). Higher corporate tax rates of 35% and 38% apply to net taxable incomes of \$10 million or more.

EXAMPLE:

Sally and Randolph run their own lumber supply LLC (S&R Wood, LLC). Because they know that they'll need to keep profits in the business to buy new equipment and increase inventory, they elect corporate tax treatment for S&R Wood. Sales for the year are \$1.2 million, and after paying business expenses, including salaries and bonuses to the working members, S&R shows a \$70,000 net taxable profit. This is taxed at the corporate rates of 15% on the first \$50,000 and 25% on the next \$20,000. If Sally and Randy had not elected corporate tax treatment for their LLC, these profits would be passed along to them and taxed at their higher individual income tax rates.

If you decide that being taxed like a corporation is what you want—with separate corporate tax rates applied to net income left in the business (not paid out as salaries and other deductible expenses)—you must file IRS Form 8832, as explained below. But remember—this only affects tax status, not legal status, and the company will still be treated as an LLC under state law.

A Flat Corporate Tax Rate Applies to Certain Professional Service LLCs That Elect Corporate Tax Treatment

If your LLC elects corporate tax treatment and provides professional services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting, a flat federal corporate income tax rate of 35% applies to all its net taxable income, not the lower graduated corporate income tax rates of 15% and 25% that apply to most corporations.

How LLCs Report and Pay Federal Income Taxes

In this section, we look at what, if anything, your LLC needs to do to qualify for the type of tax status it prefers.

- **If an LLC wants pass-through tax status.** An LLC with more than one owner (member) is automatically treated as a partnership for federal tax purposes, unless it elects to be taxed as a corporation by filing IRS Form 8832. (See a copy of this form in Appendix B.) Each tax year, your LLC must prepare and file the same tax forms used by a partnership—IRS Form 1065, *U.S. Return of Partnership Income*, which includes a Schedule K-1 showing the allocation of profits, losses, credits, and deductions passed through to your members. Your LLC also must prepare and distribute to each member a Schedule K-1 form, which shows each member's allocation of LLC profits, losses, credits, and deductions. The members, in turn, use this Schedule K-1 information to complete their annual 1040 income tax returns.

If an LLC has one member and it has not elected to be taxed as a corporation using IRS Form 8832, the IRS treats the LLC as a sole proprietorship. This means business profits (and losses, credits, and deductions) are reported on Schedule C, *Profit or Loss From Business*, of the sole member's individual income tax return.

- **If an LLC wants corporate tax status.** If an LLC wants corporate tax treatment, it must check the “corporation” box on IRS Form 8832 (the line next to this box reads: “A domestic eligible entity electing to be classified as an association taxable as a corporation”). The election takes effect on the date you specify on the form, but this date cannot be more than 75 days before or more than 12 months after the date the form is filed. So a new LLC that wishes to start out being taxed as a corporation should file this election within 75 days of the date its articles of organization are filed with the state LLC filing office. An election to be taxed as a corporation cannot normally be changed for 60 months (five years), but there are exceptions to this rule—for example, the LLC can ask to change its tax status within the five years of its election if there has been a 50% or greater change in LLC ownership.

An LLC that has elected to be taxed as a corporation must file a corporate tax return, IRS Form 1120, for each year the corporate tax election is in effect. The LLC pays income taxes on profits left in the business at corporate income tax rates, at the rates discussed in the last section.

LLCs and Self-Employment Taxes

Whether LLC members must pay federal self-employment taxes on profits is unsettled. Basically, the rule (with some exceptions—see below) is that all income a member of an LLC receives is subject to self-employment tax if the member is “active in the business.” This is a major issue for some LLC organizers who feel that the current self-employment tax rate is too high.

Some disgruntled business organizers choose to form an S corporation instead of an LLC because S corporation shareholders are required to pay self-employment taxes only on money paid to them as compensation for services, not on profits that automatically pass through the S corporation to them. Some even decide to form an LLC, elect corporate tax treatment for their LLC, and then make an S corporation tax election for their LLC. This is a lot of work to avoid self-employment taxes on allocated LLC income, but some business owners don’t mind if it reduces taxes.

What does “active in the business” mean? Some tax practitioners look to the rules that the IRS tried to pass on the issue. These proposed regulations were withdrawn by the IRS, but they still provide guidance on how the IRS is likely to view things. According to the proposed regulations (proposed Treasury Regulation Section 1.402(a)-2(h)(2) and following), an LLC member must pay self-employment taxes on his or her share of LLC profits if the member:

- participates in the trade or business for more than 500 hours during the LLC’s tax year, or
- works in the LLC and the LLC renders professional services in the fields of health, law, engineering, architecture, accounting, actuarial science, or consulting.

The above regulations were not adopted, but they can be useful in helping you or your tax adviser decide if you are active enough in your LLC to worry about paying self-employment tax on your share of LLC profits.

State Law and the Tax Treatment of LLCs

As you know, LLCs are regulated by state law. This means you must organize and operate your LLC under the provisions of your state’s LLC laws, in addition to following the federal tax rules. The main sources of state regulation that impact an LLCs tax treatment can be found in the state’s LLC act and in its tax statutes and regulations.

State Tax Statutes and Regulations

How will your state classify your LLC for state income tax purposes? Probably exactly the same as the IRS. To find out, just call your state tax department (better yet, go online to the state tax office website—see Appendix A) and ask—or see—if your state follows the current federal tax classification system for business entities. If you call or email the office, one easy way to ask is: “If my LLC is classified as a partnership, sole proprietorship, or corporation under the IRS rules, will the state tax department do the same?” If they say “No,” ask them exactly how your LLC will be treated or ask your tax adviser to fill you in.

Other LLC Formation Tax Considerations

Let’s turn to two other tax issues that may arise when you’re forming your LLC:

- tax liability for members who contribute services or property to start the LLC, and
- the division of LLC profits and losses among LLC members.

The types of questions raised here relate to partnership tax law (the LLC inherits the complexities and benefits of this branch of tax law). Specifically, we will focus on questions that are likely to arise as you fill in your LLC operating agreement (as part of Chapters 5 or 6).

This field is a specialty all to itself, so if your questions are important enough, it makes sense to buy yourself some specialized tax advice to find an answer. (See Chapter 8 and consider asking your regular LLC legal or tax adviser for a referral to a partnership tax specialist.)

Capital Contributions of Services or Property

Let's start with some background on how start-up LLCs are usually funded. The initial members, like partners in a partnership, ordinarily make financial contributions to the business. In return, each member normally gets a percentage (capital) interest in the LLC. This capital interest reflects how much of the business's assets a member is entitled to if and when the business is liquidated and establishes a relative value for the membership interest when it is sold prior to a sale of the LLC itself. For example, a member with a 50% capital interest in an LLC receives \$25,000 when the business sells for \$50,000 (an oversimplified example, but makes the basic point).

In addition to receiving a stake in the LLC's assets upon liquidation, LLC members are also entitled to share in its profits and losses during the life of the LLC. Typically, divisions of profits and losses parallel LLC members' capital interests, although they may be distributed disproportionately. Disproportionate splits of profits and losses are called "special allocations"

under the tax law and are subject to special rules, discussed below.

EXAMPLE 1:

Tony and Lisa set up Elk-n-Stuff LLC. Both members contribute equal amounts of start-up capital. In their operating agreement, Tony and Lisa agree that each member has a 50% capital interest and will receive 50% of the business's profits (or losses).

EXAMPLE 2:

Tony and Lisa set up the same Elk-n-Stuff LLC, but this time Tony puts up the cash, while Lisa signs over her interest in an equal amount of property that can be used by the LLC (an interest in a lease and some retail store counters and equipment). Tony will work full time in the LLC, but Lisa only part time (and neither will be paid a guaranteed salary). They agree that Tony will have a 50% capital interest and will receive 75% of the business's profits (or losses) for the first two years. Lisa will have a 50% capital interest and will get 25% of the business's profits (or losses) during the business's initial two years—after that, both members will split LLC profits and losses 50-50. Tony gets the extra share in recognition of his full-time commitment to the LLC. Note: For technical reasons, the LLC operating agreement makes it clear that Lisa's capital interest is given in return for her contribution of property, not for her agreement to work in the LLC (see "Contribution of Services," below, for information on contributing services to the LLC).

Under most state statutes, members may make capital contributions of cash, property, or services—or the promise to provide any of these

in the future. As we discuss in the remainder of this section, any member who contributes property or services should take into account several important tax considerations.

Cash Contributions

When all members contribute cash, there are no special tax consequences. Skip below to “Special Allocations of Profits and Losses” to read about special profit and loss rules that may affect your LLC.

Contribution of Services

If a person is given a capital interest in an LLC in return for performing services, the IRS views this as payment for personal services rendered. So, if the operating agreement allocates capital contributions in exchange for a member’s (often unpaid, future) services, that person will have to pay personal income tax on the value of the services.

EXAMPLE:

Five Austin computer programmers start Future Tex LLC. Four put up \$20,000 each as 20% capital contributions. Cash-strapped Sharon is allotted her 20% membership in exchange for a promise to work for the company for six months without pay. The IRS considers this \$20,000 capital interest as Sharon’s personal income. She will be liable for personal income taxes on the entire \$20,000 (to be estimated and paid by her during the year).

Reporting and paying personal service income on the value of the capital interest in an LLC can be painful for the service-contributing member, who may have to wait to receive income from the LLC to be able to pay the taxes that result from joining the LLC. Fortunately,

the following options may get around this income tax liability problem:

- **A profits interest only.** A member who’s contributing services can be given an interest in the profits of the LLC, but not a capital (percentage) interest in LLC assets. In this situation, as long as the amount of profits to be paid to the members is not clearly discernible or predictable (see IRS Revenue Procedure 93-27), income taxes normally are not due until profits are actually paid to the member. This may be easier for the member, who should at least receive some cash closer to the time when taxes must be paid.

EXAMPLE:

Hubert Allis Overalls, Ltd. Co. (HAO), a supplier of denim fabric to clothes manufacturers, brings Hank Allis (son of founding member Hubert) to help run the LLC. Business is busting at the rivets, with HAO supplying fabric to all leading domestic brand-name jeans manufacturers. In return for signing a ten-year employment contract, Hank is given a 25% stake in LLC profits, plus a guaranteed annual salary. Because Hank does not receive a capital interest in the LLC, he will not be taxed up front on his promise to perform services for HAO.

But note the following additional points:

- Even if a profits-only interest is issued to a member, the member may owe taxes if the interest is sold or transferred within two years of its issuance grant.
- Under Treasury Regulation 105346-03, LLCs and their members must follow special rules, adopt special agreements, and make sure that special tax elections are filed by persons receiving LLC interests in return

for the performance of services within 30 days of the issuance of the interests to obtain favorable tax treatment of that interest.

Ask your tax adviser how to comply with these and the other special rules and requirements before you decide to issue profits or other LLC interests in return for the performance of services. For more information, see Notice 2005-43, “Proposed Revenue Procedure Regarding Partnership Interests Transferred in Connection With the Performance of Services,” available at www.irs.gov (although the notice speaks in terms of partnership interests, it also applies to LLC interests).

- **A loan to buy a capital interest for cash.** A member can get a loan from the LLC, another member, or an outside source to buy a capital interest. To help define and secure repayment of the loan, the member may be asked by the lender to sign a promissory note specifying repayment terms, including interest. The lender may also require a pledge of property as security for repayment.

EXAMPLE:

Bella and Xavier form Happy Hoofs Equestrian Academy and Stables LLC, with the idea of operating a horse-riding and boarding facility in Riverside, California. Bella can contribute \$50,000 in cash and property as her stake in the new business—enough to finance a down payment on a barn with surrounding acreage that can be converted to a stable with riding trails. Xavier is low on funds, but champing at the bit with energy that he’ll use to fix up and convert the farm. Bella agrees to loan Xavier the money to become a cash member of the LLC at the

start. Xavier will receive a capital interest without having to pay taxes on the value of the future services he promises to perform for the LLC. Instead, as Xavier gets paid for his services, he can pay Bella back (of course, he’ll also pay individual income taxes on the salary the LLC pays him).

- **Buy into membership later.** Yet another approach is for a member wannabe to hold off joining the LLC until he or she has the cash to buy in. For example, a person can enter the LLC ranks as an employee and buy a capital interest in the LLC (assuming the members agree) with savings the employee socks away out of earned LLC salary.

EXAMPLE:

Let’s return to the Happy Hoofs Equestrian Academy and Stables LLC. Bella and her husband, Clyde, form the LLC as the two initial members. Xavier bides his time to buy into the LLC. He does not become a member right away, but simply works for the ranch as a regular employee and saves his money. When Xavier has sufficient cash, he buys out Clyde’s capital interest in the LLC.

Capital Contribution of Property to an LLC

Tax technicalities also arise when a member wants to contribute property to the LLC that has appreciated (increased in value) since the time it was purchased, inherited, or otherwise received. Ordinarily, this will involve “real” property—a fancy way of saying an interest in land or a building—although this discussion applies to personal property (collectibles, airplanes, and so on), too.

First the good news. Contributions of property to an LLC are generally tax free at

the time they occur. The tax consequences are generally realized later when the LLC or a member's interest in it is sold. (By the way, this is one benefit of forming a pass-through tax business, such as an LLC or partnership: Corporations are not so kindly treated and transfers must pass muster under technical "control tests" to be tax free.)

The not-so-good news is that the member who transferred the property must pay taxes on the appreciation (increase in value) that occurred prior to the transfer, either when the LLC is sold or when the member sells his or her LLC interest. This member's income tax basis (known simply as "basis") in the property carries over to the member's basis in the LLC. The result is that taxes due from appreciation on the property transferred to the LLC are paid later when the member's LLC membership is sold, not when the property is contributed to the LLC. The following example illustrates how this works.

EXAMPLE:

Jim buys a building for \$500,000. It is worth \$600,000 when he transfers it to his newly formed LLC (it has appreciated \$100,000). For the transfer of this property, he receives a \$600,000 capital stake in his LLC. Jim's basis in the property is \$500,000 (his cost—for simplicity, we assume there have been no adjustments to the basis; in real life, it increases with capital improvements and decreases as depreciation is taken on property). Jim pays no taxes at the time of transfer, but his basis in his LLC membership becomes \$500,000 (his basis in the real property at the time of transfer).

Assuming no further adjustments to Jim's basis in his LLC membership (another unrealistic but convenient assumption), when the LLC is liquidated or sold, or when

Jim sells his interest in the LLC, his gain—the amount he will have to pay taxes on—will equal the amount he receives for the sale of his LLC interest minus his basis. In other words, if Jim sells his interest back to the other members for \$600,000 (assuming his interest is worth the same amount when he sells as when he bought it), then he will have to report a gain of \$100,000 and pay taxes on that amount at the time of sale.

There are additional complexities when real property is contributed to an LLC. For example, separate tax issues arise when real property is encumbered (subject to a mortgage or other debt). This liability needs to be reflected on the LLC books, and also has bearing on gains or losses realized by LLC members during the life of the LLC and when the business or membership interests are later sold. The bottom line: Before transferring property to your LLC, ask your tax adviser about any immediate and deferred tax consequences.

Special Allocations of Profits and Losses

Like partnerships, LLCs are subject to special IRS rules if members decide not to follow the standard practice of splitting up profits and losses proportionately with each member's capital contribution. A disproportionate split of profits and losses is known as a "special allocation"—for example, if a member who contributes 10% of the initial LLC cash is allocated a 20% share of profits and losses.

Although special allocations are perfectly legal, the IRS has pages upon pages of regulations designed to handle them. Basically, these regulations say that for special allocations of profits and losses to be valid (recognized and accepted by the IRS), they must have

“substantial economic effect.” In other words, special allocations should not be made simply to lessen the tax burden of the owners. For instance, the IRS might object if, without placing a real economic burden on a member, an LLC allocated all its losses to a member with significant income from non-LLC sources, simply so that member can fully deduct these losses and scale down on his or her personal income taxes.

EXAMPLE:

Up Up and Away Ventures, LLC, is a passive investment company that puts investors’ money into business operations run by others. Its prime moneymakers are multitiered parking garages located in inner city business districts, plus a widely dispersed network of vending machines installed at suburban shopping malls. Joe and Kenneth have invested equally, and each holds a 50% capital interest in the business. Joe wants to be allocated most of the LLC deductions for the first two years, when he will be in the 35% income tax bracket, and Kenneth wants to be allocated most of the income, because he is in a low tax bracket. Will the IRS object? Probably, unless the LLC makes sure that Joe’s capital account is decreased by his allocated deductions and, conversely, that Ken’s capital account is increased by his allocated share of LLC income.

If the IRS audits an LLC’s tax returns—or the returns of its members—and does not approve special allocations, it will reallocate income and losses of the LLC according to each member’s interest in the LLC. This usually means that the IRS will reallocate income and losses to members according to each member’s capital interests.

IRS Safe Harbor Rules for Special Allocations

The IRS has adopted complex regulations that show LLC owners (their tax advisers really) how to make adjustments to their capital accounts so that special allocations made to them will be approved by the IRS as having substantial economic effect to the owners. Generally, these “safe harbor” rules require an LLC to make adjustments to members’ capital accounts for special allocations. Because capital accounts define each member’s economic interest in the LLC, and because members normally must look to the capital account to determine how much (or little) each would receive on the liquidation of the LLC, making the capital accounts track special allocations ensures that special allocations of income or loss will have real economic consequences for each member.

So as long as your operating agreement requires your LLC to maintain its capital accounts and make other adjustments according to the safe harbor rules, all of your special allocations should have “substantial economic effect” under IRS regulations. As a practical matter, that means including special language, from Internal Revenue Code Section 704(b) (“704(b) language”), in your operating agreement.

EXAMPLE:

Cuneiform Widgets Works Ltd. Liability Co. is founded by Sol Shimmaker. The business makes wedge-shaped objects of all descriptions, including a unique form-fitting doorstop named the Toe-Hold 2000. Expanding orders spur Sol on to seek additional capital to retool and expand CWW’s fabrication facilities. Sol’s friends Arnie and Lillian have the bucks and agree to contribute an amount of cash equal to half of the existing capital of the enterprise. They insist, however, on receiving a five-year

65% profits interest in the Toe-Hold 2000, plus a 50% share of net profits derived from other CWW product sales. The LLC asks its tax adviser to prepare and add 704(b) language to its operating agreement, which requires it to maintain its capital accounts under the safe harbor rules and requires members to restore any deficits in their capital accounts when the LLC liquidates or in other specified circumstances, to make sure its special allocations will be respected by the IRS.

Effect of Safe Harbor Rules

There are some real financial and tax consequences associated with adopting 704(b) language in your LLC operating agreement—after all, that’s the purpose of these rules. Generally, the lengthy series of provisions that you must adopt in your operating agreement to satisfy the IRS safe harbor special allocations rules come down to these basic points:

- The business’s capital accounts must be set up and maintained on the financial books under special rules based on Section 704(b).
- Distributions of cash or property to owners upon liquidation of the business must be made in accordance with capital account balances maintained under Section 704(b), as mentioned just above.
- When an owner leaves, or the business is sold or liquidated, any partners or members

with negative capital account balances (capital accounts go negative if members are allocated losses in excess of their capital account balance) must restore their accounts to zero balances. They do this by contributing cash or property equal to their negative capital account balances before their interests, or the LLC itself, is sold or liquidated.

- Rule #3 can result in an LLC member’s being personally liable for LLC losses—because the member has to pay back money to the LLC if allocation of losses to that member has caused his or her capital account to fall below zero. The safe harbor regulations provide an alternative rule that tax advisers can add to an LLC operating agreement (called a qualified income offset provision) that can help limit an LLC member’s personal liability for a negative capital account balance.

If you want to make special allocations of profits or losses in your LLC, do what a big business would—hand your operating agreement over to a partnership or LLC tax specialist to see if you should insert the technical IRS safe harbor rules in your operating agreement. These rules are lengthy and complex. For all these reasons, plus the fact that most smaller LLC owners will not wish to make special allocations of profits and losses, we don’t include them in the operating agreements provided in this book.



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In this chapter, we explain how to prepare articles of organization for your LLC and file them with your state LLC filing office. Once you perform this important task, your LLC will be a legal entity recognized by your state, as well as other states.



TIP

Don't be concerned if your state uses different LLC terminology. Different states use different legalese in their LLC statutes, regulations, and bureaucracies. We have tried to use the most common terms to describe LLC documents and offices, but your state may use other language. For example, although we refer to the charter document used to form an LLC as the articles of organization, some states use a different name such as a "certificate of formation" or a "certificate of organization."

Go to Your State's LLC Filing Office Online

Each state has its own requirements for preparing and filing LLC articles of organization. Go to your state's LLC filing office online to read your state's official articles form with instructions and other information provided there (see Appendix A to locate your state's LLC filing office online).

Each state's LLC website operates a little differently, but most states are likely to supply a number of helpful materials, including:

- fill-in-the-blank or sample LLC articles of organization with instructions
- a fee schedule showing current charges for filing, copying, and certifying various LLC documents
- forms and instructions to check LLC name availability and reserve an LLC name for your use

Prepare Your Articles of Organization and Other LLC Legal Forms With Nolo's Online Service or Software

Nolo's online LLC formation service helps you form your LLC directly on the Internet. Once you complete a comprehensive interview online, Nolo will create your articles of organization and file them with the state filing office, prepare a customized operating agreement, and assemble other essential legal forms for your LLC.

The LLC online service is available at www.nolo.com.

- forms and instructions for post-formation procedures—these may include materials to amend LLC articles, change the LLC's registered office or registered agent, or register an assumed or fictitious LLC name (one that is different from the official LLC name shown in the articles of organization), and
- a summary or complete listing of the state's LLC act.

All states provide an online articles form (or a sample form with instructions) or an LLC online formation service (with the latter, you don't need to prepare a form; just answer some questions). The sample form in this chapter should help you fill in your state's form, follow your state's form sample instructions, or answer its online questions.

Choose a Name for Your LLC

When you prepare your LLC articles of organization, you'll need to supply the name of your LLC. If the name, or one similar to it, is already in use by another LLC on file with the LLC

filing office, your articles of organization will be returned unfiled to you. It pays, therefore, before you complete your articles, to plan ahead and check whether your proposed LLC name is available. Take a little time to read through the material in this section and to choose a good name for your LLC.

Choosing a Unique LLC Name

Our primary task is to show you how to choose a name that is not already in use—one that is acceptable to your state’s LLC office when you file your articles.

Name Cannot Resemble Another Business’s Name

Make sure your proposed name is not very similar to any famous business name (McDonald’s, Procter & Gamble, The Quaker Oats Company, Honda, and the like). If so, you shouldn’t use the name, even if it is available for use by an LLC in your state. Companies with famous names and marks are fanatical about protecting them.

Name Cannot Infringe on Trademarks or Service Marks

If the name you choose is the same or similar to one already registered by another business (LLC or otherwise) as a federal or state trademark or service mark, the other business may be able to sue you for trademark or service mark infringement. The infringed business may also stop you from continuing to use your name to market your goods or services, and may seek money damages from your LLC.

What Are Trademarks and Service Marks?

A trademark generally consists of a distinctive word, phrase, or graphic symbol that is used to identify a product and distinguish it from anyone else’s. Well-known trademarked products include Ford cars and trucks, IBM computers, and Kellogg’s cereals.

A service mark promotes services in the same way that a trademark promotes products. Some common service marks are Blue Cross (sells health insurance) and Greyhound (transports people by bus).

We show you several things you can do to help satisfy yourself that your proposed LLC name is not in use by others as a federal trademark or service mark, in “Performing Your Own Name Search,” below.



RESOURCE

How to learn more about trademark

law. Get a copy of *Trademark: Legal Care for Your Business & Product Name*, by Stephen Elias and Richard Stim (Nolo), which you can purchase online at www.nolo.com. In addition to educating you about trademark law, the book will help you choose a strong marketing name, search for possibly conflicting trademarks and service marks, and, if the circumstances warrant, register your LLC name as a mark with state and federal trademark agencies. For a general overview of trademark law and other intellectual property law, you may be interested in *Patent, Copyright & Trademark: An Intellectual Property Desk Reference*, by Richard Stim (Nolo).

If Your LLC Name Will Identify Products or Services

Businesses often market goods or services using a name that is different from their company name—for example, Bausch & Lomb manufactures Renu® contact lens cleaner. Companies

do, however, frequently use (and register) their business names as trademarks or service marks: the Rug Doctor (company) puts out The Rug Doctor® MightyPro (product) and McDonald's Corp. uses "McDonald's" as a service mark. And of course, many companies use their business name together with additional words and symbols to make up trademarks and service marks for their products and services—for example, Apple Computer Corporation uses the name Apple® Macintosh for its personal computer line.

If your LLC decides to use its business name as, or as part of, a trademark or service mark to identify products or services, you will face a number of issues:

- Is the name identical or similar to any trademark or service mark being used on goods or services that are similar or related enough to yours to likely cause marketplace confusion? To answer this you will need to conduct what's called a trademark search.
- Assuming your name doesn't conflict with an existing mark, do the circumstances justify the time and expense involved in placing the name on the federal trademark register and/or your state's trademark register? If you do the work yourself, you can easily keep costs to a minimum.

Don't overlook these important additional legal chores now if you anticipate marketing goods or services later under your proposed LLC name. If you hastily choose a name for your LLC and later use it to promote product sales in a competitive market, you may face a legal conflict just when business is humming, and your LLC and its product or service names are beginning to become known.

State LLC Name Requirements

Your LLC name must conform to your state's legal requirements. Check the name requirements listed on your state's filing office website (usually the LLC name requirements are listed in the instructions to the state's online articles form). Most states' LLC name requirements incorporate the basic rules that follow.

LLC Designator Is Required in LLC Name

Your LLC name must normally include an LLC designator, such as "Limited Liability Company" or "Limited Company." Capitalization is normally not specified under state statutes—upper or lower case may generally be used for these words.

You must, however, follow your state's specific rules for abbreviations. Some states allow both "LLC" and "L.L.C." as acceptable abbreviations; others stick with one of these two forms. Further, the words "limited" and "company" can usually be abbreviated as "Ltd." and "Co.," but you normally can't abbreviate the word "liability"—for example, "Liab." is not a valid abbreviated form. The result is usually that the words "Limited Liability Company" can be abbreviated in most states to "Ltd. Liability Co."

EXAMPLE:

Valid names for the ABC limited liability company would typically include one or more of the following:

- ABC Limited Liability Company
- ABC Limited Liability Co.
- ABC Ltd. Liability Co.
- ABC Limited Company
- ABC Ltd. Co.
- ABC L.C.

- ABC L.L.C., or
- ABC LLC.

Finally, realize that in a minority of states, you may be required to place the LLC designator—the words “Limited Liability Company” or one of the other approved LLC designators—at the end of your LLC name. For example, you’d have to settle on “Maladroit Ventures LLC,” not “Maladroit LLC Ventures.” So be on the lookout for this requirement as you read the instructions to your state’s articles form.

Certain Words Are Prohibited or Restricted in LLC Name

An LLC name usually cannot include words reserved for use by special businesses. In many states, prohibited words include references to banking, insurance, trust companies, or similar financial service businesses.

Many states either prohibit regular (non-professional) LLCs from practicing certain state-licensed professions, such as law, accounting, medicine, engineering, and architecture, just to name a few, or require that they set up professional LLCs and operate under special rules. If professional LLCs are allowed in your state, it normally requires the LLC name to include special designators, such as “Professional LLC” or “P.L.L.C.” If you are forming a professional LLC, check your state’s professional LLC name requirements online to be sure.

LLC Name Must Not Conflict With a Name Already On File

Another state LLC name requirement is that your LLC name must not be the same as, or too closely similar to, the name of an LLC already on file with the state LLC filing office. Names on file that are not available for your LLC may include the names of:

Important Business Name Facts

There’s a lot of misinformation and confusion about choosing names for LLCs and other businesses. Here are a few points of clarification:

- **Filing your LLC name with the LLC filing office does not guarantee your right to use it.** We’ve said this already, but it bears repeating: Another business may be able to prevent you from using the name if the other business is already using your LLC name (or one close to it) in a trademark or service mark to identify goods or services.
- **You are allowed to use a name that’s different from the official name shown in your articles of organization.** If you do, this alternate name is known as an assumed or fictitious business name, and you may need to register it at the state and/or county level. (See “Filing a Fictitious or Assumed Business Name Statement,” in Chapter 7.)
- **You can change your official LLC name later by amending your articles.** You may later decide to change the name of your LLC to a new name (again, that name must be available for your use with the LLC filing office) by amending your articles of organization. Naturally, most LLC owners choose not to change their LLC name after they have been in business for a while, but this option is available if absolutely necessary.
- domestic LLCs (those formed in the state)
- foreign LLCs (registered out-of-state LLCs that have qualified to do business in the state), and
- names on reserve for LLCs in the process of formation (names being held for 30 to 120 days for businesses planning to form LLCs soon; see “Reserve Your LLC Name,” below).

If your proposed LLC name is similar to another name already on file with the state LLC office, some states allow you to use it anyway if you can get the other business's written approval to use your similar name. But there are problems with this approach. For starters, the other business is likely to refuse to let you use the similar name unless you carefully limit or distinguish it in some way from its own name. Even if the other business does agree, it probably will ask you to pay big bucks to use any version of the name. In addition, it's messy to use a name already in use by others—even if you get their permission.



TIP

Some states also check proposed LLC names against names of other business structures.

In some states, if your proposed LLC name is the same or similar to one in use by a corporation or limited partnership, you will not be able to use it.

So, if you find that your proposed LLC name resembles one already on file with your state LLC office (or generally conflicts with a name you discovered in your search, explained in “Performing Your Own Name Search,” below), we recommend you come up with another name.

Check Availability of LLC Name With the State

Let's say you've come up with a name or two that you'd like to use for your LLC. How can you find out if the name is available for your use? Simple. Often you can check the availability of your name online from the state filing office website. Many states provide a name search link while others simply let you search the state filing office database of registered names. Either way, you should be able to find any obvious name conflicts using the online links.

Alternatively, call your state LLC filing office and ask. The state LLC office will normally tell you over the phone, at no charge, whether one or two proposed names are available for your use. A few offices will ask you to send a written name availability request. If this happens, we suggest you use a written letter to request that your proposed LLC name be reserved for your use if it is available. (We show you how in “Reserve Your LLC Name,” below.)



CAUTION

Don't count on using a name that you haven't reserved or filed. An online, telephone, or written name check is just a preliminary indication of the availability of your proposed LLC name. Unless you formally reserve your name, you do not secure your right to use the name until you file your articles of organization with the state LLC office. So don't order your business stationery, cards, signs, or anything else until your name has been secured for your use (after your articles have been filed with the LLC filing office, or after reserving your name, if you are absolutely certain that you will file your articles within the reservation period).

Performing Your Own Name Search

There are a few simple name searching procedures you can use, in addition to checking the availability of your name with the state LLC office, to find out if your proposed LLC name is in use by other businesses. Why is this important to know? For one thing, most business owners would like their names to be unique.

Another reason, mentioned earlier, is that you'd like to stay clear from names already being used by other businesses to market their goods and services. This not only helps you avoid names that others will lay legal claim to as trademarks and service marks, but can help you if you wish to use your LLC name yourself as a

registered state or federal trademark or service mark (to identify and market your LLC's goods and services).

Below are several self-help search techniques you can employ to see if others are using a name similar to your proposed LLC name. If you decide to perform any of these steps, it makes sense to do so before filing your LLC articles, to avoid having to amend your articles to change your name if you find it is already in use by another business.

- **Check state and county assumed business name files.** Your state filing office website should indicate whether assumed (or fictitious) business names are registered with your Secretary of State's office, at the county level, or both. If they are registered at the state level, call the assumed or fictitious business name section of the Secretary of State's office and ask if your proposed LLC name is the same or similar to a registered assumed or fictitious name. (Assumed or fictitious names normally do not appear in the searchable online name databases maintained by the state.) Or, call your local county clerk's office to ask how you can check assumed business name filings; in most states, assumed or fictitious business name statements, or "doing business as" (dba) statements, are filed with the county clerk's office. Generally, you must go in and check the assumed business name files in person—it takes just a few minutes to do this.
- **Check business directories.** Check such sources as major metropolitan phone book listings, business directories, and trade directories to see if another company or group is using a name similar to your proposed LLC name. These directories often can be searched online. Also, larger public libraries keep phone directories for many

major cities throughout the country, as well as trade directories.

- **Check state trademarks and service marks.** Call the trademark section of your Secretary of State's office and ask if your proposed LLC name is the same or similar to trademarks and service marks registered with the state. Some offices may ask for a written request and a small fee before performing this search. Also, some states may let you search your state's trademark database online. If so, you should see a link to the trademark database on your state's filing office website.
- **Check the federal *Trademark Register*.** Another logical step is to check federal trademarks and service marks. The federal *Trademark Register* consists of a listing of trademark and service mark names broken into categories of goods and services. The *Register* can be searched for free at the federal Patent and Trademark Office's website, www.uspto.gov. If you wish to search the *Register* in printed form, go to a large public library or special business and government library in your area that carries the *Register*.

Reserve Your LLC Name

Let's say you have decided on an LLC name and checked that it is available by checking online or calling your LLC filing office. Most states allow you to reserve available LLC names. During the reservation period, only you—the person who reserved a name—may file articles of organization using this name. The reservation period and the fees vary, but generally an available LLC name can be reserved for 30 to 120 days for \$10 to \$50. In many states, you can reserve the same name more than once if you don't get around to filing your articles of organization during the first reservation period.

It makes sense to reserve your name if you will not be filing your articles of organization immediately. Start by checking your state's online information. A sample or fill-in-the-blank reservation of LLC name form may be available, or you may find instructions for preparing one from scratch. Also note: Some states now let you reserve a name online. Filing a name reservation online is the quick and easy way to reserve a name, and we suggest you use this method if your state provides it.

Your state's online fee schedule should show how much you must pay for a name

reservation, as well as indicate the period of reservation.

If the state LLC filing office does not provide a form online, you can use the tear-out LLC Reservation of Name Letter included in Appendix B. Following is a sample with instructions.



FORMS

Where to find forms in this book. If you're reading a print copy of this book, you'll find copies of the LLC Reservation of Name Letter form on the CD-ROM that comes with the book. If you're using

Sample LLC Reservation of Name Letter

[date]

[name and address of your state's LLC filing office]

LLC Filings Office:

Please reserve the following proposed limited liability company name for my use for the allowable period specified under state law:

[insert your proposed LLC name; make sure it conforms to your state's name

requirements]

☐ If the above name is not available, please reserve the first available name from the following list of alternative names: ❶

Second choice: _____

Third choice: _____

I enclose a check in payment of the reservation fee. ❷ Please send a certificate, receipt for payment, or other acknowledgment or approval of my reservation request to me at my address shown below.

Thank you for your assistance,

[your signature]

❸

[your name, address, and phone number]

Enclosures: check for reservation fee; stamped, self-addressed envelope

an eBook version, you can download this form on the Nolo website; the link is included in Appendix C. Both the print copy and eBook versions include tear-out versions of the forms (found in Appendix B) and filled-in samples in the text.

Special Instructions for LLC Reservation of Name Letter

- ❶ You may wish to include alternative names in case your first choice is not available. In that case, check the box and fill in the names in the blanks below.
- ❷ Include a check or money order for fees.
- ❸ Make sure that the person signing this letter will be available to sign articles of organization on behalf of your LLC. The LLC name is reserved for this person's use only. (If the requesting person drops out of the LLC, some states will allow that individual to file a transfer of reservation of name form.)

Check Your State's Procedures for Filing Articles

Below, we cover the general procedures and rules for preparing and filing articles of organization for LLCs. Make sure you check your state's online information for important rules or procedures that may apply in your state (see Appendix A for contact information).



TIP

File online. If you have the option of filing your articles online, you should use it because it's much easier and eliminates the time and trouble of printing, filling in, and mailing paper articles.

Additional Filing Procedures

The laws and regulations of some states include special requirements when filing LLC articles of organization. Most common are:

- **Supplemental forms.** An additional legal or tax form may be required to be filed with your articles. For example, a separate designation of registered agent and office, a standard industry code form that you check to show the LLC's primary business, or a state tax form may be included in your LLC materials to be completed and submitted with your articles. These extra forms should be available for downloading from your state website.
- **Publication of notice.** Some states require a pre- or post-filing publication in a legal newspaper of your intention to do business as a limited liability company. A local legal newspaper can handle this.

Special Requirements for Licensed Professionals

In some states, licensed professionals can form LLCs as long as they comply with additional requirements or filing formalities. For example, some states allow licensed professionals to form an LLC as long as they file a special form of articles of organization for a Professional LLC and the LLC name ends with the words "Professional Limited Liability Company" or the abbreviations "PLLC" or "P.L.L.C." Your state's website should alert you to special requirements, but double check with your profession's state licensing board to be sure.

The special state rules that apply to professional LLCs typically limit LLC membership to licensed professionals only (and, generally, to the particular licensed profession only). Other rules may apply as well—for example, minimum malpractice insurance coverage or

bonding may be required for each practicing member.

Typically, lawyers, doctors, accountants, engineers, and health care professionals must abide by these extra rules, but other licensed professions may be subject to these rules, too. To find out whether any special professional LLC rules apply to your licensed profession, call the state board or agency that regulates your profession and ask, “May I form a limited liability company in this state to render licensed professional services of [your field]?” If the answer is yes, ask whether any special requirements apply to operating your professional LLC in the state. If so, ask to be sent a copy of these special rules.

Prepare LLC Articles of Organization

The articles of organization form is your primary formation document: Your LLC comes into existence on the date you successfully file the articles with your state LLC filing office. Here’s how to go about preparing it.

Locate Articles for Your State LLC Materials

All state LLC filing office websites provide LLC articles of organization forms (or instructions to prepare the form) that meet the state’s basic statutory requirements. More and more states also provide an LLC formation service, which eliminates the need to prepare articles—just answer a few questions and your online “articles” are automatically filed. Unless you plan to organize an LLC with a complicated organizational structure (with the help of a lawyer, accountant, or other specialist), the basic state form or online formation service will work fine.

How to Complete Articles of Organization

The basic clauses required in most states’ LLC articles of organization are similar. Below, we provide sample language and explanations for provisions you are likely to find in the articles provided by your LLC filing office and required under your state’s LLC statutes. You’ll find a tear-out form containing all the provisions discussed here in Appendix B.

By following the material below and referring to the specific instructions for preparing articles of organization provided by your LLC office online (or the statute that lists the required contents of LLC articles in your state), you should be able to prepare your own articles without difficulty (or answer the online formation service questions). Here are some hints to make this job easier:

- **Scan our sample articles of organization.** Glancing through the language of our sample articles below will help you get a general idea of the types of provisions included in standard LLC articles of organization. This overview will help you understand the form and instructions provided by your LLC office.
- **Use instructions as guidance.** If you get stuck with a particular article or provision in a state-provided form or question, refer to our instructions below for a similar item in our sample form.



FORMS

Where to find forms in this book. A sample LLC articles of organization form is included on the CD-ROM at the back of this book. If you’re reading a print copy of this book, you’ll find copies of the LLC Articles of Organization form on the CD-ROM that comes with the book. If you’re using an eBook version, you can download this form on the Nolo website; the link is included in Appendix

Customizing Your Articles of Organization

Although the standard articles of organization discussed in this chapter and the form normally provided by your state will be sufficient for most LLCs, you may wish to include special operating rules or provisions. Ordinarily it is preferable to cover such special rules in your operating agreement, which can be adopted and changed with relative ease, rather than in the articles (amended articles must be refiled with the state LLC office).

You may, however, need to place certain special provisions in the articles for them to be effective. Most state-provided articles forms and services contain an “Other Provisions” section where you can add your own provisions. For example, if an LLC wants to adopt the following types of provisions, they must often be included in its articles of organization:

- management of the LLC by designated managers

- appointment of a manager or member by a designated person or group, rather than by all members, or
- indemnification (payment of legal expenses) of LLC members or managers under special provisions of state law.

You won’t normally have reason to be concerned with provisions of this sort—but if you do, your state’s articles instructions may indicate any special provisions that must be included in the articles to be effective. (The state LLC statute that contains the list of required information in articles almost always lists special items of information that need to be placed in articles, rather than in the operating agreement, if the LLC wishes to adopt them. For further information and for help customizing your articles with special provisions, check your state’s LLC statutes (see Appendix A to locate your state’s LLC act) or consult an LLC business lawyer.)

C. Both the print copy and eBook versions include tear-out versions of the forms (found in Appendix B) and filled-in samples in the text.

We’ll start at the top of the articles and discuss each part of the form separately. Each provision is shown, followed by explanatory text, including instructions for filling in blanks in a given provision.

Heading of Articles

Articles of Organization

Some states use a different title for this document—for example, “Certificate of Formation.”

Statement of Statutory Authority

The undersigned natural person(s), of the age of eighteen years or more, acting as organizer(s) of a limited liability company under the State of [name of state] Limited Liability Company Act, adopt(s) the following articles of organization [or other title for form, such as “Certificate of Formation”] for such limited liability company.

Although not required, it is traditional in many states to include a preliminary statement of statutory authority after the heading to the articles of organization and before the first article. This statement just means that you are filing the articles under the state’s laws and intend them to be legally recognized. You will

normally see language of this sort on state-provided forms.

Name of Limited Liability Company

Article 1. Name of Limited Liability

Company. The name of this limited liability company is [name of LLC].

Insert the proposed name of your LLC in the blank. This should be identical to the name listed in the heading. Make sure your LLC name is available for your use, as discussed earlier in this chapter.



TIP

Numbering or lettering of articles of organization. State law does not normally specify any particular numbering or lettering scheme for articles. We employ Arabic numerals, but other number or letter sequences are used—such as “Article One,” “Article I,” or “Article A.”

Name and Address of Initial Registered Office and Agent

Article 2. Registered Office and

Registered Agent. The initial registered office of this limited liability company and the name of its initial registered agent at this address are: [name and address of LLC initial registered agent and office].

Most states require that articles of organization include both of the following:

- **The name of the LLC’s initial registered agent.** The agent is sometimes called the “agent for service of process.” He or she is authorized to receive legal papers on behalf of the LLC. Typically, the agent must be a resident of the state and at least 18 years of age.
- **The address of the initial registered office.** The registered office is the address where the agent maintains a place of business—where

papers may be mailed, and where service of process (the delivery of official legal papers) can be personally performed on the agent.

The registered office address must be located in the state.

Although the registered office may be different from the principal office of the LLC (the actual office or business location of the LLC) in many states, most LLCs keep things simple and appoint one of the members as the initial agent, showing the principal address of the LLC as the registered office address. Usually, this must be a street address, not a post office box.

Some states supply a separate “Designation of Registered Agent” form (or one with a similar title) to be filed with the articles, which the agent signs to show his or her consent to act as registered agent for the LLC. Other states require only a simple statement at the end of the articles, signed by the initial agent—such as, “The undersigned hereby accepts appointment as registered agent for the above named limited liability company.”



TIP

Don’t needlessly hire a registered agent company. Most states allow you to designate another business as a registered agent, and some companies specialize in acting as registered agents for an annual fee. Because acting as a registered agent simply involves being available to receive mail (and personal service), most readers will handle this task themselves and need not bother to hire an outside firm.

Some states also require an LLC to designate the Secretary of State or another state official as the person who is entitled to receive legal notices on behalf of the LLC in case the registered agent resigns, cannot be located, or is otherwise unable or unavailable to act as agent for the LLC in the future. In some states, this designation of state official as alternate agent

happens automatically as a matter of law; in other states, specific language to this effect is included in the articles. The sample articles provided by your state should include any required language.

Statement of Purposes

Article 3. Statement of Purposes. The purposes for which this limited liability company is organized are:

[list purposes of the LLC business, for example, “to operate a computer repair and retail store, and to engage in any other lawful business for which limited liability companies may be organized in this state.”]

Many states include a statement of purposes in the articles of organization. Some say that a general statement of purposes is sufficient—that is, “to engage in any lawful business for which limited liability companies may be organized in this state.” Others states require a brief statement of the specific business purposes of the LLC—usually a short and straightforward description of the particular type of business to be operated by the LLC.

If a specific statement of business purposes is required, it is often a good idea to follow it with a general statement of purposes—allowing the LLC “to engage in any other lawful business for which limited liability companies may be organized in this state.” Adding this general language makes it clear to the organizers, future LLC members, and others who may read your articles that your LLC, while formed for one particular purpose, can engage in other business activities (but your LLC can engage in any lawful business whether or not you include this language). The sample language above contains a dual-purpose statement of this sort.

Here are some other examples of how to complete this statement:

- “to open and operate a car stereo and security alarm sales and service facility, and to engage in any other lawful business for which limited liability companies may be organized in this state”
- “to purchase, sell, and otherwise invest in real property and commercial interests in real property, and to engage in any other lawful business for which limited liability companies may be organized in this state,” or
- “to provide financial consulting services to individuals and businesses, and to engage in any other lawful business for which limited liability companies may be organized in this state.”

Management of the LLC

Article 4. Management and Names and Addresses of Initial [“Members” or “Managers”]. The management of this limited liability company is reserved to the [“members” or “managers”]. The names and addresses of its initial [“members” or “managers”] are: [names and addresses of members or managers].

Articles of organization usually state whether the LLC will be member-managed or manager-managed (discussed in detail in Chapter 2). Here’s a recap of what these terms mean:

- **Member-managed LLC.** This means the LLC’s members will manage the business. It is the default rule in most states—if you don’t specify how your LLC will be managed in your articles, your LLC will be managed by all the members.
- **Manager-managed LLC.** Some LLCs decide to specifically appoint some of the members and/or nonmembers as managers of the LLC. If so, the articles should provide a

space to state that management is reserved to managers, and allow you to list the names and addresses of the specially designated managers. Normally, just one manager is required. If managers are listed, members' names and addresses usually are not required, but in some states, you may be asked to list the names and addresses of members and managers separately (even if some individuals function in both capacities).

In each of the first sets of blanks, indicate whether your LLC will be managed by "members" or "managers." All states now allow an LLC to be formed with just one member. You may of course have more members. In the indicated space, list the names and addresses of the LLC's initial members or managers. Normally, street (not post office box) addresses must be shown.

Principal Place of Business

Article 5. Principal Place of Business of the Limited Liability Company. The principal place of business of the limited liability company shall be: [street address of principal office of LLC].

The articles of organization often specify the principal place of business of the LLC. Though this location may be within or outside the state, most LLCs will show the address of its main office located in the state. Technically, the principal place of business listed in the articles is one of the places where the business may be sued (brought to court), not necessarily the place where most of the business operations of the LLC are performed. For most smaller LLCs, there's only one place of business, and you will list it here.

Duration of the LLC

Article 6. Period of Duration of the Limited Liability Company. The period of duration of the limited liability company shall be: ["perpetual" or "from the date these articles of organization are filed through and including (give future date or state a period of years)"].

In some states, the articles of organization include a provision specifying the duration of the LLC.

In most states that include this provision in the articles, it's permissible to provide for a "perpetual" (unlimited) duration in this provision. If you have this option, you probably will want to take it—so your LLC automatically continues into the future until your members vote to dissolve it.

A small (and decreasing) number of states may not let you provide a perpetual duration for your LLC. Instead, you must limit its duration to a number of years from the date the articles are filed or to a specific date in the future. A state may even say that this date can't be more than 30 or 50 years into the future. Don't worry about any of these limitations. If you must limit the life of your LLC in your articles under state rules, choose a date that is as far in the future as you can. If your LLC is still around after whatever termination date you are forced to select, you or your LLC successors can file an amendment extending the legal life of the LLC for as long as your state's laws allow.

Signatures of Persons Forming the LLC

In witness whereof, the undersigned organizer(s) of this limited liability company has (have) signed these articles of organization on the date indicated.

Date: _____

Signature(s):

[typed or printed name], Organizer

[typed or printed name], Organizer

[typed or printed name], Organizer

[typed or printed name], Organizer

[typed or printed name], Organizer

States have various signature requirements for LLC articles of organization. In most states, one person may act as organizer of the LLC by signing the form and submitting the articles for filing. The usual practice is to have one of the initial members who is listed in the articles of organization date and sign the form as the LLC organizer. If managers are listed instead of members in the articles, a manager will usually sign the form and act as organizer of the LLC.



TIP

If your LLC's name was reserved, the person who reserved your LLC name with the state should sign your articles as one of its organizers. If that person is not available, check with your LLC filing office, which may allow you to file a transfer of reservation of name or similar form, signed by the person who reserved your LLC name.

Use an Articles Conversion Form to Convert an Existing Business to an LLC

State entity-filing offices have made it simple to convert one type of entity to another—for example, to convert an existing partnership to an LLC. Many provide a simple form (often called a certificate of conversion) for this purpose. Just check the appropriate boxes on the conversion form, add some simple boilerplate as explained in the instructions to the form, file the form, and you're done. The new business is formed, the assets of the old business are transferred to the new business, and the old business is dissolved. All of this happens automatically by operation of law according to each state's entity conversion statute. Go to your state's website to see if your state provides a conversion form. See Chapter 7 for additional information on converting your business to an LLC.



CAUTION

Check with your tax adviser before you use a special articles conversion form to change an existing business to a new LLC. When you exchange assets in return for interests in a new business (your new LLC), by operation of law you will want to make sure the tax treatment of the transaction, including the tax basis each member gets in their LLC interest, will end up the way you want—that is, you pay or don't pay the taxes you expect and members get a tax basis in their LLC membership that they expect.

Articles of Organization

The undersigned natural persons, of the age of eighteen years or more, acting as organizers of a limited liability company under the Anystate Limited Liability Company Act, adopt the following articles of organization for such limited liability company.

Article 1. Name of Limited Liability Company. The name of this limited liability company is Luxor Light LLC.

Article 2. Registered Office and Registered Agent. The initial registered office of this limited liability company and the name of its initial registered agent at this address are:

Robert Johnston, 1515 San Estudillo, Anycity, Anystate, 00000.

Article 3. Statement of Purposes. The purposes for which this limited liability company is organized are:

to operate a custom home and commercial lighting and fixture
store, and to engage in any other lawful business for which
limited liability companies may be organized in this state.

Article 4. Management and Names and Addresses of Initial Members. The management of this limited liability company is reserved to the members. The names and addresses of its initial members are:

Robert Johnston, 1515 San Estudillo, Anycity, Anystate, 00000

Rebecca Johnston, 1515 San Estudillo, Anycity, Anystate, 00000

Gregory Luxor, 3021 Los Avenidos, Anycity, Anystate, 00000.

Article 5. Principal Place of Business of the Limited Liability Company. The principal place of business of the limited liability company shall be:

56 Rue de Campanille, Anycity, Anystate, 00000.

Article 6. Period of Duration of the Limited Liability Company. The period of duration of the limited liability company shall be: perpetual.

In witness whereof, the undersigned organizer of this limited liability company has signed these articles of organization on the date indicated.

Date: 11/05/20xx

Signature(s): Gregory Luxor
Gregory Luxor, Organizer

The signature statement on your state articles of organization may look a little different from the sample form. For example, in some states, people must sign under penalty of perjury.

In a few states, the articles must be notarized—signed in the presence of a notary public, who fills out a concluding notarization statement and impresses a notarial seal at the bottom of the form (notary statements vary from state to state). Notaries are found in real estate offices and other businesses, or simply by looking up “Notary” in a local telephone directory. Notary fees are usually modest.

LLC Organizer Does Not Have to Be a Member or Manager

Typically, the organizer does not need to be a member or associated with the LLC in any way; in most states the organizer must be at least 18 years of age. What the states have in mind here is to allow a lawyer to prepare, sign, and file your articles for you—but you will usually tend to this task yourself by selecting at least one of your initial members or managers as your organizer.

Sample Completed Articles of Organization

To help you tie all this information together, we include a sample completed articles of organization form, above. The articles are prepared for a fictitious business, “Luxor Light LLC,” a three-member LLC for a lighting fixture business. The sample is relatively standard; note that in Article 4, Luxor Light has opted to be managed by members (the option most LLCs will choose).

Finalize and File Your Articles of Organization

If you download an articles form, it is normally provided in Adobe Acrobat PDF format. You may need to print the form out and then fill in the blanks with a typewriter or by printing neatly. Alternatively, you may be able to fill the form in and print it from your browser, then mail it. As a third alternative, many states now allow you to fill in and submit the form online without printing or mailing, as part of the state’s online LLC formation service.

File your articles of organization with your state LLC filing office following your state’s official instructions. Many offices will accept articles in person if you can’t file your articles online and you are in a rush. If you mail your articles, remember to keep an extra copy in case the original is lost in the mail.

In Appendix B, we include a filing letter that you may wish to use to submit your articles of organization to the state LLC filing office (if you file by mail); if your state office website provides a cover letter, use it instead of our form cover letter. If you use our form cover letter, complete it following the sample and special instructions below. Your state website will have the most current fee and mailing address information.



FORMS

Where to find forms in this book. If you’re reading a print copy of this book, you’ll find copies of the LLC Articles Filing Letter form on the CD-ROM that comes with the book. If you’re using an eBook version, you can download this form on the Nolo website; the link is included in Appendix C. Both the print copy and eBook versions include tear-out versions of the forms (found in Appendix B) and filled-in samples in the text.

Sample LLC Articles Filing Letter

[date]

[name and address of your state's LLC filing office]

LLC Filings Office:

I enclose an original and [number] ❶ copies of the proposed articles of organization of [name of LLC], ❷ a proposed domestic limited liability company.

Please file the articles of organization and return a file-stamped copy of the original articles or other receipt, acknowledgment, or proof of filing to me at the address below.

A check/money order in the amount of \$ [filing fee amount], ❸ made payable to your office, for total filing and processing fees is enclosed.

❹ ☐ The above LLC name was reserved for my use [if applicable, insert "according to reservation number" and the reservation number], issued on [date of issuance].

Sincerely,

❺ [your signature]

[your printed or typed name], Organizer

[your address and phone number]

Enclosures: articles of organization; check

**TIP****If you have problems filing your articles.**

The filing office may return your articles and indicate which items need correction (your check should be held until you fix the problem). Often the problem is technical, not substantive, and easy to fix. If the problem is more complicated, such as an improper or insufficient LLC purpose clause, you may be able to solve the problem by rereading the instructions earlier in this chapter and those provided online for preparing articles. If you get stuck, you will need to do a little research or obtain further help from an LLC lawyer who's experienced in drafting and filing LLC articles of organization in your state. (See Chapter 8.)

Special Instructions for LLC Articles Filing Letter

❶ In some states, you need only submit an original of the articles—the LLC office will file the original and send you a file-stamped copy or file receipt. In other states, you need to submit the original and one or more copies. The LLC filing office will file the original and file-stamp and return one or more copies to you.

Depending on the state, an additional fee may be charged for submitting more than one copy of your articles for file-stamping. One copy (plus the original) should be sufficient in most cases; you can always make copies of this file-stamped copy to keep in your LLC records book or give to others as the need arises.

❷ Enter the proposed name for your LLC (the name stated in your articles of organization). As explained above, it can be risky to file articles with a name that you haven't checked ahead of time. We recommend checking the availability of your proposed name before filing articles or reserving the name for your exclusive use. If you don't, and the desired name is unavailable, your articles will be returned unfilled.

❸ Include a check (or money order) for the total fees, made payable to the state or state office. Remember to consult your state website for particulars.

❹ If you reserved your LLC name, check the box. Then fill in the blanks to show the certificate number and/or date of issuance of your reservation of LLC name. In some states, the LLC filing office simply sends you a file-stamped copy of your reservation letter—if so, just fill in the file-stamped date of the name reservation letter in the second blank, and include a copy of your file-stamped reservation certificate with this cover letter.

❺ The person (or one of the persons) who is acting as organizer of your LLC—by signing your articles—should sign this filing letter. If an LLC name was reserved, the person who reserved the name should sign this letter—and the articles of organization as well—since the LLC name is reserved for this person's use.

What to Do After Filing Articles of Organization

Once you've sent in your articles for filing, your next step is to wait. The LLC filing office will make sure the LLC name is available for use and that your articles conform to law. If there are no problems, the office will mail you a file-stamped copy of your articles or a filing receipt.

Once your articles of organization have been successfully filed, your business is a legally recognized limited liability company.

Although filing articles of organization is all you are legally required to do to establish the legal existence of your LLC, make sure you go at least one step further and prepare an operating agreement for your LLC—see Chapter 5 if your LLC will be member-managed or Chapter 6 if your LLC will be

manager-managed. This agreement sets out the basic legal rules for operating your LLC.

Finally, don't miss Chapter 7, where we cover some of the ins and outs of tending to your new LLC. ●

Prepare an LLC Operating Agreement for Your Member-Managed LLC

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If you've turned to this chapter, we assume you have already formed or are in the process of forming your LLC by preparing and filing articles of organization with your state LLC filing office, as explained in Chapter 4. Here, you'll learn how to prepare a fill-in-the-blanks operating agreement for a member-managed LLC, covering the basic rights and responsibilities of LLC members, including each member's percentage interest in the LLC, the tax year and accounting method you're using, and capital contributions by members.



SKIP AHEAD

Manager-managed LLCs. Most LLCs will be member-managed—that is, managed by all members. If, however, you plan to adopt a manager-managed LLC (one managed by only some LLC members and/or by nonmembers), you'll need an operating agreement that provides for manager-management. Chapter 6 will cover that in detail, but you'll need to read the first two sections of this chapter first—they discuss areas of LLC operation not covered elsewhere, as well as information about how to customize your operating agreement.

Customizing Your LLC Operating Agreement

The sample operating agreements we supply in this book are relatively straightforward forms that cover basic LLC issues. Our agreements simply help you set up your LLC under sensible ground rules and contain necessary reminders about restrictions that apply to most LLCs under state law. As you create your own LLC operating agreement, you may want to add or change provisions to suit your needs. Modifying or writing LLC operating agreement provisions is simple using the forms on the CD-ROM included in this book. It is not akin to brain

surgery, and you can ordinarily do much of it yourself—just use common sense and your own sound business judgment.

If you wonder whether state law has established any guidelines you must follow in an area of your LLC's operation, simply check your state's LLC act to make sure your rule does not conflict with a specific statute (see Appendix A to locate your state's LLC act online). You may also want to ask a legal or tax adviser about the validity or effect of your custom-crafted provisions, or if you want to significantly customize the agreement. We think consulting an expert is a good idea for any changes you feel are important—such as special voting rights for certain members or special voting requirements to amend your articles of organization or to approve the dissolution of the LLC. (For guidance on self-help research and finding an LLC legal or tax adviser, see Chapter 8.)

Here's a brief summary of the different types of changes you can make to the included agreement, and a quick assessment of how safe you are in making them on your own. We provide more specific advice in the detailed special instructions that follow.

- **Internal matters.** Internal LLC housekeeping provisions are your own business. For example, you may choose to specify how and when member or manager meetings will be held or who qualifies to be an officer or employee in your LLC. If you want to put rules such as these in your operating agreement, you should be safe doing so; state LLC statutes and the tax rules have little or nothing to say about internal issues of this sort.
- **Legal procedures.** If you wish to change a legal procedure—such as the number of votes necessary to dissolve your LLC, amend your articles of organization, or effect a similar structural change—check to

see if legal rules affect your desired change. If you browse your state's LLC act online, it should take just a few minutes to see if state law has placed limitations or restrictions on the provisions you are thinking of adopting.

- **Tax matters.** Tax matters are a little trickier. We recommend showing your LLC tax adviser any changes to your operating agreement that may have tax effects—for example, provisions dealing with the sale of assets, allocation or distribution of profits, and the like. A tax adviser can tell you if your proposed operating agreement changes are good, bad, or neutral from a tax perspective.

EXAMPLE 1:

Hank forms an LLC with friend and former business partner Max. Hank has cash and Max doesn't. Max signs a note, promising to pay his investment to the LLC (together with interest) over time. It's decided that even though each person ultimately will contribute equally to the capitalization of the LLC, Hank should get an extra share of the profits for putting up cash in one lump sum at the start of the business operations and that Max's capital account probably should be handled differently because he hasn't contributed anything to the LLC yet. They ask their tax adviser to check their operating agreement, because special allocations (a disproportionate division) of profits may have tax consequences and require the addition of special provisions to their operating agreement. Their tax adviser adds IRS special allocations language to the agreement that restates technical tax regulations related to sharing profits and losses disproportionately. The adviser also tells them that IRS regulations say that Max's capital account should be credited only if

and when, and to the extent, that he makes payments to the LLC under the terms of his promissory note. In other words, his capital account—and his basis in his LLC interest—will start at zero.

EXAMPLE 2:

Kenneth and Francine decide to lower the membership vote requirement in their LLC member-managed operating agreement to approve the transfer of LLC interests to outsiders. First, they check their state's LLC act, which provides the basic state rules and whether the state lets LLC organizers change these rules. They ask their legal adviser to check their changes.

How to Prepare a Member-Managed LLC Operating Agreement

Appendix B contains a basic operating agreement for a member-managed limited liability company (the first of two agreements in Appendix B). If you wish to prepare this form, tear it out now so you can follow along, making sure that you don't miss any pages or inadvertently take pages from the other (manager-managed) operating agreement, also in Appendix B. Alternatively, fill in the operating agreement form provided on the disk (see Appendix C for list of forms on the disk and instructions on using them).



FORMS

Where to find forms in this book. If you're reading a print copy of this book, you'll find copies of the Operating Agreement for Member-Managed Limited Liability Company form on the CD-ROM that comes with the book. If you're using an eBook version, you can download this form on the Nolo

website; the link is included in Appendix C. Both the print copy and eBook versions include tear-out versions of the forms (found in Appendix B) and filled-in samples in the text.

We'll start at the top of the agreement and work our way through it. We provide instructions for filling out items in the sample agreement below. To help you complete some of the more complicated information, we provide additional instructions in the special instructions that accompany the sample operating agreement. These are organized by major section, such as Preliminary Provisions. Special instructions are numbered sequentially as they occur in the sample agreement. The first page of the sample agreement appears on the next page.

Special Instructions for Operating Agreement for Member-Managed Limited Liability Company

I. Preliminary Provisions

This section covers basic information such as the effective date of the agreement and the name of the LLC.

- ❶ Insert the name of your LLC exactly as shown in your articles of organization.
- ❷ Insert a date that is on or after the date all your members sign this operating agreement (you'll have your operating agreement signed as the last step in preparing this form). If you aren't sure how long it will take to do this, simply insert the words "the last date of signing shown at the end of this agreement."
- ❸ All members will sign the agreement at the end of this process.
- ❹ Insert the date and year your articles of organization or certificate of formation was filed with your state LLC filing office. In most cases, this date will be shown as the "file-stamped" date on the first page of the filed

articles or certificate, or on a filing receipt mailed to you from the state LLC filing office.

❺ This paragraph states that your LLC is allowed to do business under another name—one that is different from the formal LLC name stated in your articles of organization and operating agreement. In that event, you may need to register a fictitious or assumed business name with the state, as well as each county where you will use the fictitious business name. (See Chapter 7 for more information.)

❻ Most articles of organization specify the LLC's registered office and agent—if yours do, just copy the information from your articles of organization into this blank. (We cover this in Chapter 4.) Typically, the registered office address must be a street address (not a post office box) located in the state. Most states require the agent to be at least 18 years of age and a state resident. Usually, a founding member of the LLC will act as initial agent and show the principal office address of the LLC as the registered office address.

As this paragraph specifies, you may change your LLC's registered agent and office by filing a form with your state LLC filing office. If and when you do so, there is no need to go back and change this information in your operating agreement.

❼ In plain English, specify the business purposes of your LLC. You may have listed specific business purposes in your articles of organization. If so, you can copy that information into these blanks.

Mostly, this statement is meant to let your own members know what your plans are for the LLC's business operations, so feel free to expand your statement of purposes to provide as much detail as you want. Here are some examples:

- "to open and operate a car stereo and security alarm sales and service facility"

Sample Operating Agreement for Member-Managed LLC

Operating Agreement for Member-Managed Limited Liability Company

I. Preliminary Provisions

[Here we address preliminary matters, such as the effective date of the agreement, the name of the LLC, and other basic information.]

(1) Effective Date: This operating agreement of _____ *[name of LLC]* ^① _____, effective _____ *[date]* ^② _____, is adopted by the members whose signatures appear at the end of this agreement. ^③

(2) Formation: This limited liability company (LLC) was formed by filing articles of organization, a certificate of formation, or a similar organizational document with the LLC filing office of the state of _____ *[state of formation]* _____ on _____ *[date of filing articles of organization, certificate of formation, or similar organizational document]* ^④ _____. A copy of this organizational document has been placed in the LLC's records book.

(3) Name: The formal name of this LLC is as stated above. However, this LLC may do business under a different name by complying with the state's fictitious or assumed business name statutes and procedures. ^⑤

(4) Registered Office and Agent: The registered office of this LLC and the registered agent at this address are as follows: _____ *[name and address of registered agent and office]* _____.

The registered office and agent may be changed from time to time as the members may see fit, by filing a change of registered agent or office form with the state LLC filing office. It will not be necessary to amend this provision of the operating agreement if and when such a change is made. ^⑥

(5) Business Purposes: The specific business purposes and activities contemplated by the founders of this LLC at the time of initial signing of this agreement consist of the following:

_____ *[state the specific business purposes and activities you foresee for your LLC]* ^⑦ _____

It is understood that the foregoing statement of purposes shall not serve as a limitation on the powers or abilities of this LLC, which shall be permitted to engage in any and all lawful business activities. If this LLC intends to engage in business activities outside the state of its formation that require the qualification of the LLC in other states, it shall obtain such qualification before engaging in such out-of-state activities.

- “to purchase, sell, and otherwise invest in real property and commercial interests in real property,” or
- “to provide financial consulting services to individuals and businesses.”

⑧ A few states require the articles of organization to specify the duration of the legal existence of the LLC, as discussed in Chapter 4. If so, insert this same time period here. If you had to specify a limited duration for your LLC under state law, remember: You can always amend your articles to extend the legal life of your LLC as the termination date approaches.

If your articles are silent on this issue, your state most likely does not require you to limit the duration of your LLC’s legal existence, and you can insert the word “perpetual” in the blank. Your state’s LLC information should indicate if your state has any special rules for limiting the life of your LLC.

Finally, notice that the concluding sentence of this provision makes it clear that the LLC can always be terminated by a vote of the membership and as otherwise allowed by law. (See “VI. Dissolution Provisions: (1) Events That Trigger Dissolution of the LLC,” in this operating agreement, and the corresponding special instructions ③⑧ through ④①, below.) We include this sentence as a reminder that members have the ultimate say as to when the LLC will wind up its affairs and dissolve.

II. Membership Provisions

This section covers rights and responsibilities of LLC members.

⑨ Although there is no legal requirement that you insert this statement of nonliability in your agreement, we think it’s a good idea to include it as a basic restatement of this important state law protection.

⑩ This paragraph authorizes the LLC to reimburse its founders for LLC formation

expenses advanced by members, such as filing fees, legal fees, and tax fees.

Also included is a reminder that the Internal Revenue Code allows businesses to deduct a portion of organizational and start-up expenses, in their first year, then to amortize (deduct over time) the remainder of the expenses over future years. Your tax adviser can tell you more about these important tax elections and how to implement each of them on your first and subsequent LLC informational tax return.

⑪ This provision makes it clear that all members will manage your LLC. If you want to provide for management by some, but not all, members, you need to adopt the management agreement covered in Chapter 6, not this agreement. For a discussion of this important management decision, see “Responsibility for Managing an LLC,” in Chapter 2.

⑫ This paragraph defines an important LLC formula: the calculation of each member’s percentage interest in the LLC. This percentage will be used later in the agreement to:

- allocate profits and losses of the LLC to members
- allocate voting rights among the members
- distribute assets of the LLC when it is liquidated, and
- value a member’s interest when it is sold to an outsider or back to the LLC.

This percentage is arrived at by computing a fraction that reflects the proportion of each member’s capital account to the total of all members’ capital accounts. Each member’s capital account starts with the amount of money or value of property that member contributed at the outset of the LLC, plus any additions to or minus any distributions from or other adjustments to this account.

Sample Operating Agreement for Member-Managed LLC (cont'd)

(6) **Duration of LLC:** The duration of this LLC shall be ["perpetual" or any specific termination date or term of years for the LLC, as specified in the articles of organization]. Further, this LLC shall terminate when a proposal to dissolve the LLC is adopted by the membership of this LLC or when this LLC is otherwise terminated in accordance with law. ⑧

II. Membership Provisions

[Here we cover provisions that deal with the rights and responsibilities of your LLC's members.]

(1) **Nonliability of Members:** No member of this LLC shall be personally liable for the expenses, debts, obligations, or liabilities of the LLC, or for claims made against it. ⑨

(2) **Reimbursement for Organizational Costs:** Members shall be reimbursed by the LLC for organizational expenses paid by the members. The LLC shall be authorized to elect to deduct and amortize organizational expenses and start-up expenditures as permitted by the Internal Revenue Code and as may be advised by the LLC's tax adviser. ⑩

(3) **Management:** This LLC shall be managed exclusively by all of its members. ⑪

(4) **Members' Percentage Interests:** A member's percentage interest in this LLC shall be computed as a fraction, the numerator of which is the total of a member's capital account and the denominator of which is the total of all capital accounts of all members. This fraction shall be expressed in this agreement as a percentage, which shall be called each member's "percentage interest" in this LLC. ⑫

(5) **Membership Voting:** Except as otherwise may be required by the articles of organization, certificate of formation, or a similar organizational document; by other provisions of this operating agreement; or under the laws of this state, each member shall vote on any matter submitted to the membership for approval in proportion to the member's percentage interest in this LLC. Further, unless defined otherwise for a particular provision of this operating agreement, the phrase "majority of members" means the vote of members whose combined votes equal more than 50% of the votes of all members in this LLC, and a majority of members, so defined, may approve any item of business brought before the membership for a vote unless a different vote is required under this operating agreement or state law. ⑬

(6) **Compensation:** Members shall not be paid as members of the LLC for performing any duties associated with such membership, including management of the LLC. Members may be paid, however, for any services rendered in any other capacity for the LLC, whether as officers, employees, independent contractors, or otherwise. ⑭

EXAMPLE:

Barbara, Bill, Fred, Francis, and Mike start their LLC by each contributing \$5,000 cash. Each member's capital account currently shows a positive \$5,000 balance and each member has a 20% interest in the LLC. This figure is the result of dividing each member's \$5,000 capital account balance by the \$25,000 total capital account balance for all members, resulting in the fraction one-fifth, expressed as a percentage interest of 20%. The percentage interests of the members will be listed in Section IV (Capital Provisions) of the agreement (see Instruction 25, below). (According to subsequent provisions in the agreement, each person is allocated 20% of the profits and losses of the LLC and is entitled to a 20% share of the LLC's total voting power.)

**SEE AN EXPERT**

You may base interests in your LLC disproportionately. For example, you could decide that anyone who contributes cash to your LLC is entitled to a 10% increase in the standard percentage interest (with other members' interests reduced accordingly). If you wish to come up with your own method, ask your tax adviser to make sure that you will meet the requirements of IRS regulations relating to special allocations of profits and losses, discussed in detail in Chapter 3.

13 This provision gives each member voting power equal to that member's percentage interest in the LLC—for instance, a 10% member gets a 10% vote on any matter. This is standard practice, although you can base voting rights on some other measure if you wish. Here are some possibilities:

- each member gets one vote on all membership matters—known as per capita voting

- members get different numbers of votes each—you can even decide to make one or more members nonvoting members by specifying that they have zero votes, or
- each member's vote depends on his or her share in the profits of the LLC (if the members' share of profits, or "profits interests" differ from percentage interests).

If you decide to opt for your own membership voting scheme, delete this paragraph and substitute your own wording. For example, if a four-member LLC wishes to specify specific voting power for three members, and make the fourth a nonvoting member, it could replace the standard provision in the agreement with the following wording:

Except as otherwise may be required by the articles of organization, certificate of formation, or a similar organizational document; by other provisions of this operating agreement; or under the laws of this state, the members of this LLC shall have the following voting power:

Member 1: 1 vote
Member 2: 2 votes
Member 3: 2 votes
Member 4: 0 votes

Further, unless defined otherwise for a particular provision of this operating agreement, the phrase "majority of members" means the vote of members whose combined votes equal more than 50% of the votes of all members in this LLC, and a majority of members, so defined, may approve any item of business brought before the membership for a vote unless a different vote is required under this operating agreement or state law.

**TIP**

This sample operating agreement includes special voting provisions that apply to transfers of membership and continuation of the

Sample Operating Agreement for Member-Managed LLC (cont'd)

(7) Members' Meetings: The LLC shall not provide for regular members' meetings. However, any member may call a meeting by communicating his or her wish to schedule a meeting to all other members. Such notification may be in person or in writing, or by telephone, facsimile machine, or other form of electronic communication reasonably expected to be received by a member, and the other members shall then agree, either personally, in writing, or by telephone, facsimile machine, or other form of electronic communication to the member calling the meeting, to meet at a mutually acceptable time and place. Notice of the business to be transacted at the meeting need not be given to members by the member calling the meeting, and any business may be discussed and conducted at the meeting.

If all members cannot attend a meeting, it shall be postponed to a date and time when all members can attend, unless all members who do not attend have agreed in writing to the holding of the meeting without them. If a meeting is postponed, and the postponed meeting cannot be held either because all members do not attend the postponed meeting or the nonattending members have not signed a written consent to allow the postponed meeting to be held without them, a second postponed meeting may be held at a date and time announced at the first postponed meeting. The date and time of the second postponed meeting shall also be communicated to any members not attending the first postponed meeting. The second postponed meeting may be held without the attendance of all members as long as a majority of the percentage interests of the membership of this LLC is in attendance at the second postponed meeting. Written notice of the decisions or approvals made at this second postponed meeting shall be mailed or delivered to each nonattending member promptly after the holding of the second postponed meeting. ¹⁵

Written minutes of the discussions and proposals presented at a members' meeting, and the votes taken and matters approved at such meeting, shall be taken by one of the members or a person designated at the meeting. A copy of the minutes of the meeting shall be placed in the LLC's records book after the meeting. ¹⁶

(8) Membership Certificates: This LLC shall be authorized to obtain and issue certificates representing or certifying membership interests in this LLC. Each certificate shall show the name of the LLC and the name of the member, and state that the person named is a member of the LLC and is entitled to all the rights granted members of the LLC under the articles of organization, certificate of formation, or a similar organizational document; this operating agreement; and provisions of law. Each membership certificate shall be consecutively numbered and signed by one or more officers of this LLC. The certificates shall include any additional information considered appropriate for inclusion by the members on membership certificates.

LLC after a member leaves. These special provisions will take precedence if they conflict with any of the provisions of the basic LLC membership rule specified here.

14 This paragraph says that members will not be paid in their capacity as members or member-managers of the LLC. It does, however, allow compensation in any other capacity—for example, the LLC may pay members who also serve as LLC officers, staff, salaried personnel, or independent contractors.

EXAMPLE:

Sally and Joe are the only two members of their member-managed LLC. Both actively operate the LLC, Sally as president and Joe as sales manager. They receive salaries for their day-to-day work, but don't receive any extra compensation simply for signing up and legally functioning as members (and member-managers) of their LLC.

15 Especially if you have previously been involved in a small corporation, you may be surprised that the operating agreement doesn't require regular membership meetings. We don't require meetings for two reasons:

- Most LLC members naturally will prefer to spend their time taking care of business, not holding and documenting formal LLC meetings. After all, you and your business associates can schedule and hold meetings for any purpose when and as you need, without having to treat them as formal LLC membership meetings.
- When you do need a formal meeting to approve an important legal formality that should be recorded in your LLC records, you can call one as provided in this clause.

Most state statutes are silent as to whether and how members' meetings are called and

held. If your state law does deal with this, the state law LLC meeting provisions are usually default rules only, so you are usually free to change them in your LLC operating agreement. To learn what, if anything, your state has to say on this subject, scan your state's LLC act. Particularly, look for a section of law titled "Meetings of Members." Be aware, however, that many meeting requirements only concern meetings by managers in *manager-managed* LLCs (the type of LLC that uses the operating agreement covered in Chapter 6). Manager-meeting provisions of this sort do not apply to a member-managed LLC.

When it comes to calling meetings, we've kept things simple and in line with the kind of flexibility normally accorded LLCs under state law: Members can decide to meet at any time with a minimum of pre-meeting formality. Further, our provision says that all members must either attend a meeting or, alternatively, that any nonattending members must agree in writing to the holding of the meeting ahead of time. This is the approach most small, closely held LLCs will wish to take—after all, the holding of a formal membership meeting is infrequent and is usually enough of a big deal to warrant attendance by everyone, or at least to require the pre-meeting consent of any member who can't attend.

We have also added an escape hatch in this provision, which allows the holding of a formal LLC membership meeting with less than unanimous attendance or consent. This provision says that a meeting may be held with only a majority of the membership (percentage) interests in attendance, if it is a second postponed meeting and the time and date was announced at the first postponed meeting. You can change this postponement procedure to suit your preference—for example, you could require two postponements (instead

of one) before permitting a meeting with less than unanimous attendance or consent. Similarly, you may wish to change the quorum requirement of such a meeting, such as to two-thirds of the per capita membership in the LLC rather than our majority of percentage interests requirement.

Some LLCs will wish to provide alternatives to face-to-face member meetings. For example, you can allow for membership action by unanimous written consent of the members (without a meeting), or provide for conference call, computer network, or video hookups and other technology-assisted ways to hold virtual meetings over the phone lines or the Internet. Frankly, we think worrying about all of this is probably a bit much for most smaller LLCs. Formal membership meetings are not commonly needed in the first place, unless big structural changes are in the works, such as amending the LLC articles of organization or approving a dissolution of the LLC. If you are considering approving a major proposal of this sort, meeting face-to-face makes the most sense anyway.

If the subject of LLC meetings sparks your interest and you want to include more detailed rules, let your imagination and good sense be your guide. Following are some examples of issues you may want to address—but before you make any changes, do take a quick look at your state LLC act to be sure there are no special rules to consider:

- You can set a time limit for calling meetings (a meeting may be held no more than 60 days or fewer than 10 days from the date of the call, for example).
 - You may want to require oral or written notice of meetings (our provision allows all sorts of methods for giving and acknowledging notice, including the use of fax machines and other electronic means).
 - You may limit the business to be conducted at a meeting to matters stated in the notice.
 - You may wish to set lower quorum requirements to hold member meetings (less than the unanimous presence or consent of members).
- 16** In Chapter 7, we show you how to document meetings and discuss the importance of keeping good records, preferably in a well-organized LLC records book.
- 17** There is no statutorily required form for LLC membership certificates, and you are not even legally required to issue them. Many LLCs don't. However, if you prepare your own certificates, you can follow the basic format for the contents of the certificates as stated in this provision, or you can modify the provision to require additional information on each certificate, such as the date of issuance and the percentage interest each member holds. Also, you should put a legend on each of the certificates—see “How to Prepare a Membership Certificate Legend,” below.
- You do not have to obtain and impress a seal of the LLC on each certificate—and, in fact, seals are becoming a bit outdated now that formal documents are routinely faxed or scanned and emailed to recipients. If you want to order an LLC seal from a local stamp maker, you can design one to your liking—state law does not contain mandatory requirements for LLC seals. Most seals in use are circular and contain the name of the LLC and year and state of formation of the LLC.

How To Prepare a Membership Certificate Legend

If you adopt and use one of the two operating agreements included with this book without making modifications, you will require the vote of all nontransferring members to admit a new member into LLC membership. See Instruction 36, below, which covers “V. Membership Withdrawal and Transfer Provisions: (2) Restrictions on the Transfer of Membership,” in this operating agreement.

This operating agreement’s “II. Membership Provisions: (8) Membership Certificates,” requires your LLC to put members on notice of the existence of these transfer restrictions—as well as any others you may adopt in your operating agreement or articles—by including a statement (a “legend”) on any membership certificates you issue. You don’t need to spell out exact transfer restrictions in your LLC membership certificate legend. Instead, you can summarize the restrictions and tell people how to get a copy of the restrictions from the LLC.

Below is a sample of a simple membership certificate legend that should accomplish these purposes. To use this legend, type or print the language below on the front of each membership certificate prior to issue; printing it in all caps and/or in boldface is a good way to ensure that it is conspicuous and will be noticed and read by anyone who looks at the certificate:

THE MEMBERSHIP INTEREST REPRESENTED BY THIS CERTIFICATE IS SUBJECT TO RESTRICTIONS ON TRANSFER, AND MAY NOT BE OFFERED FOR SALE, SOLD, TRANSFERRED, OR PLEDGED EXCEPT ACCORDING TO, AND ONLY IF ALLOWED BY, THESE TRANSFER RESTRICTIONS. TO OBTAIN A COPY OF THESE TRANSFER RESTRICTIONS, CONTACT AN OFFICER OF THIS LLC AT THE FOLLOWING ADDRESS: [insert main address of LLC].

18 This noncompetition provision limits the ability of members to own interests in, manage, or work in competing outside businesses. We don’t specify exactly what a competing business is, so you may want to add language that addresses this issue.

EXAMPLE:

“Each member shall agree not to own an interest in, manage, or work for another computer retail sales or service business, enterprise, or endeavor...”

You can be more liberal if you wish, and allow members to own, manage, or be employed by competing businesses, but we think our provision states a basic restriction that will match the wishes of most smaller LLC owners.



RESOURCE

If you want to expand the noncompetition provision, take a look at noncompetition provisions for LLCs, partnerships, corporations, and other businesses in a local law or business library. Noncompetition clauses can be found in law texts in your local law library or online. Or, you may wish to ask your LLC legal adviser to help you craft a noncompetition clause that complies with any state law restrictions.

III. Tax and Financial Provisions

This section covers tax and financial aspects of organizing and running your LLC.

19 Fill in this blank to specify the IRS income tax classification you wish to obtain for your LLC (look through Chapter 3 again first). There are three choices for filling in this blank:

- Choice #1: Insert “partnership” if you are forming an LLC with more than one member, and you do not wish to be classified as a corporation for income

Sample Operating Agreement for Member-Managed LLC (cont'd)

In addition to the above information, all membership certificates shall bear a prominent legend on their face or reverse side stating, summarizing, or referring to any transfer restrictions that apply to memberships in this LLC under the articles of organization, certificate of formation, or a similar organizational document, and/or this operating agreement; as well as the address where a member may obtain a copy of these restrictions upon request from this LLC.

The records book of this LLC shall contain a list of the names and addresses of all persons to whom certificates have been issued, show the date of issuance of each certificate, and record the date of all cancellations or transfers of membership certificates. ¹⁷

(9) Other Business by Members: Each member shall agree not to own an interest in, manage, or work for another business, enterprise, or endeavor, if such ownership or activities would compete with this LLC's business goals, mission, profitability, or productivity, or would diminish or impair the member's ability to provide maximum effort and performance in managing the business of this LLC. ¹⁸

III. Tax and Financial Provisions

[These provisions deal with tax and financial aspects of organizing and running your LLC.]

(1) Tax Classification of LLC: The members of this LLC intend that this LLC be initially classified as a ["partnership" or "sole proprietorship of the sole member" or "corporation"] for federal and, if applicable, state income tax purposes. It is understood that, subject to federal and state law requirements, all members may agree to change the tax treatment of this LLC by signing, or authorizing the signature of, IRS Form 8832, *Entity Classification Election*, and filing it with the IRS and, if applicable, the state tax department within the prescribed time limits. ¹⁹

(2) Tax Year and Accounting Method: The tax year of this LLC shall be ["the calendar year" or specify a noncalendar year period, such as "July 1 to June 30"]. The LLC shall use the ["cash" or "accrual"] method of accounting. Both the tax year and the accounting period of the LLC may be changed with the consent of all members if the LLC qualifies for such change, and may be effected by the filing of appropriate forms with the IRS and state tax authorities. ²⁰

(3) Tax Matters Partner: If this LLC is required under Internal Revenue Code provisions or regulations, it shall designate from among its members a "tax matters partner" in accordance with Internal Revenue Code Section 6231(a)(7) and corresponding regulations, who will fulfill this role by being the spokesperson for the LLC in dealings with the IRS as required under the Internal Revenue Code and Regulations, and who will report to the members on the progress and outcome of these dealings. ²¹

tax purposes—this is the response most multimember LLCs will make.

- **Choice #2:** Insert “sole proprietorship of the sole member” if you are forming a one-member LLC and do not wish to be classified as a corporation. This is the choice most one-member LLCs will make.
- **Choice #3:** Insert “corporation” if you are forming a one-member or a multimember LLC and wish to be classified as a corporation for income tax purposes. Most LLC organizers will not wish to start out with their LLC classified as a corporation, but if you do, make sure to check the “A domestic eligible entity electing to be classified as an association taxable as a corporation” box on IRS Form 8832 and file it on time, as explained in Chapter 3 (with the help of your tax adviser).

²⁰ The tax year and accounting period options available to LLCs are the same as those available to partnerships. There are several places to look for the most current information on these rules, including IRS publications and commercial tax guides at the local law or business library. (See IRS Publication 538, *Accounting Periods and Methods*, and IRS Publication 541, *Partnerships*, available on the IRS website, at www.irs.gov.) Of course, your tax adviser should be on top of any recent rules in these areas, and can help you make the right choices for your LLC tax year and its accounting method.

Here is the basic information on options for tax years and accounting methods for your LLC:

- **Generally, LLCs that are treated as pass-through entities (partnerships or sole proprietorships) must select a tax year that is the same as a majority of its members** (members with a greater than 50% interest in the profits and capital of the LLC; or the sole member of a one-member LLC). For most

LLCs, this means selecting a calendar tax year (from January 1 to December 31), which is the normal tax year for individual members.

- **If your LLC elects corporate tax treatment**, it should be able to choose a calendar tax year or a “fiscal year”—one that ends on the last day of any month except December.
- **An LLC classified as a partnership can also qualify for a fiscal tax year** other than the calendar year if it can show a good business purpose, or if it results in the deferral of not more than three months of income for LLC members. For further information, see IRS Publication 538, *Accounting Periods and Methods*.
- **LLCs may elect a cash or accrual method of accounting.** Under the cash method, the business deducts expenses when paid and reports income when received. This is the way most individual taxpayers handle income and expenses on their tax returns. Under the accrual method, the business deducts expenses when it becomes legally obligated to pay them, and reports income when the LLC becomes legally entitled to receive the income. Small, closely held LLCs may benefit from the cash method of accounting because it may allow them to defer the reporting of income and give them added flexibility in claiming deductions, so most choose this option.

However, your LLC may not be able to use the cash method of accounting if:

- it has a corporation as a member (with some exceptions)
- it is considered a “tax shelter” under IRS rules.
- it stocks an inventory of items to sell to the public, or
- it has sales of more than \$5 million per year.

Tax shelters include businesses that sell securities that are registered with the SEC (your LLC should be exempt from registration); those set up with the principal purpose of avoiding the payment of federal income taxes (most LLC founders will have a primary purpose of making money from active business operations, not tax avoidance); and those that fall under the definition of a “syndicate” (your LLC will be considered a syndicate—and therefore unable to elect the cash accounting method—if more than 35% of its losses are allocable to members who do not actively participate in the business).



SEE AN EXPERT

Select a tax year and accounting method with the help of your tax adviser. Because these are important tax decisions with significant financial and tax repercussions, it’s important to check your conclusions on picking a tax year and accounting method with your tax adviser.

21 Generally, if you have ten or more LLC members (or if any member uses more than one percentage to figure his or her shares in LLC profits, losses, credits, deductions, or other tax items—for example, a member with a 10% profits interest gets a 20% share of losses), you will need to select a “tax matters partner” and file a designation of tax matters partner with the IRS. This is someone who will deal with the IRS if tax issues arise, and will keep the other members apprised of what is going on. (You designate a tax matters partner on the LLC’s annual Form 1065 informational return. Remember, LLCs are treated like partnerships under federal tax law.)

This provision simply reminds you that your LLC may have to designate a tax matters partner. You do not have to specify in your operating agreement who will act in this capacity. You may designate someone later as

a tax matters partner, and may change this designation when and as needed. There are technical rules on who may serve as a tax matters partner for an LLC (if interested, see Internal Revenue Code Regulation § 301.6231(a)(7)-1, (a)(7)-2, found in Title 26 of the C.F.R.). Ask your tax adviser to help you pick and designate a tax matters partner if you are required to do so.

22 If an LLC is classified and taxed as a pass-through entity (partnership or sole proprietorship), LLC profits and losses are passed along to members. The members will need these figures at the end of each year, as well as other LLC information, to prepare their individual income tax returns. To this end, we include a paragraph requiring that within 60 days after the end of each tax year, all members must be provided with:

- LLC income tax returns (partnership or corporate)
- If the LLC is classified as a partnership for income tax purposes, a completed IRS Schedule K-1, *Partner’s Share of Income, Deductions, Credits, etc.* (Form 1065), and
- LLC financial statements (you can dispense with this requirement, but we think most members will regard this additional information as critical).



CAUTION

Figure out whether actual payouts will be required. Ask your tax adviser if you should add a provision to your agreement that requires the actual payout of a specified percentage of the profits allocated to each member at the end of the year. Members may need this money to pay their share of income taxes on profits allocated to them.

You can change the time frame for the LLC to provide this information—for example, within 30 days after the end of the LLC’s tax

year (instead of 60 days), but make sure to give your LLC enough time to prepare these forms and statements (Schedule K-1 must be given to each member of an LLC classified as a partnership on or by the date the LLC must file its annual Form 1065 partnership return—this means on or by April 15 for LLCs classified as partnerships with a calendar tax year). We're sure you will want to send your K-1's well before this "late" date.

23 This is a general authorization paragraph that allows the LLC to establish accounts with banks and other institutions. It allows one or more members to be designated to deposit and withdraw funds into and from these accounts, and to direct the investment of funds held in these accounts.

Note that unanimous consent is required to designate a person or persons to have this depositing/check-writing authority, but you can lessen this requirement if you wish by simply deleting the words "with the consent of all members" from the second sentence of this paragraph. You may also alter, rather than delete, the language, for example "with the consent of a majority of members."

Typically, each member of a small, closely held LLC will have depositing and check-writing authority—although, for added fiscal control, multiple signatures may be required for withdrawals that exceed a specified amount. You don't need to specify these arrangements in your operating agreement because such details will be spelled out on the signature cards and paperwork you must file with the bank when opening accounts on behalf of your LLC.

The final sentence in this paragraph is a reminder that personal funds of the LLC members may not be commingled (mixed) with the funds of the LLC. If you commingle funds, a state court may decide that you and the other members are not entitled to the limited liability

protection normally afforded an LLC, and may hold you personally liable for its debts and claims.

24 This is another one of our "reminder" provisions to make it clear that the LLC will not commingle (mix) or confuse title to property. LLC property will only be owned by and in the name of the LLC.

IV. Capital Provisions

This section covers capital contributions, allocations, and distributions by and to LLC members.

25 Here is an important provision in your agreement, where you specify who pays what to the LLC to get it started.

In most states, there are no minimum capitalization requirements for LLCs. You can start an LLC with a large amount of cash or property, or on a shoestring.

Capital contributions may include cash, property, or a promise to pay cash or property in the future—for example, one member agrees to provide future services as a contribution and another to pay a specified amount of cash to the LLC within a certain time limit. Check your state's LLC act for restrictions on the types of consideration that may be paid as capital contributions—see Appendix A to locate your state's LLC act online.



CAUTION

Capital contributions may have tricky tax consequences. Particularly problematic are contributions of appreciated property and the contribution of services to an LLC. We discuss potential problems that can occur with these types of capital contributions, such as increased personal income taxes for members, in Chapter 3. To avoid problems, we strongly suggest you talk to your tax adviser before settling on the particular capital contribution scenario you will follow to fund your LLC—if all members won't be paying cash up front.

Once you've ironed out the details of members' contributions, you're ready to fill in the blanks in this provision. In the first blank, specify a date or period when capital contributions must be made by the members—such as “30 days from the signing of this agreement.”

Here's how to fill in the remaining blanks:

- **Name.** On separate lines, list the name of each contributing LLC member. If you need more space than we've provided, add more lines or fill in the words “See Attachment 1” and provide the information on a separate sheet of paper labeled “Attachment 1.”
- **Contribution.** Describe each member's contribution. If a member is contributing cash, fill in the amount. If a member is contributing property, describe it in plain language. If a member will make payments of money, transfer property, or contribute services to the LLC as a capital contribution in the future, you must describe the timeline and general terms for those future payments or services. If you wish, you can insert the specifics of members' future payments here (the date specified for members' contributions in the first paragraph of this provision applies only if you do not specify a later date for payment here). If you need more room, which is likely, fill in the words, “See the [schedule/bill/promissory note] attached to this agreement as Attachment 1” (or another numbered attachment, as the case may be). Then attach a separate document that spells out the details of each member's initial capital contribution to the LLC.

EXAMPLE 1:

Jeremy will contribute \$10,000 in cash as his capital contribution. He can come up with only half the cash now, and agrees

to pay the balance in six months. The description of his capital contribution reads as follows: “\$5,000 cash on or by the date indicated above for contributions by members, and payment of an additional \$5,000 on or by June 15, 20xx.”

EXAMPLE 2:

John contributes a promise to pay \$10,000 in cash to his LLC as his capital contribution. The description of John's contribution is: “\$10,000 to be paid per the terms of a promissory note attached to this agreement as Attachment 1.”

EXAMPLE 3:

Tom will pay cash of \$1,000 to his LLC, plus a promise to contribute \$6,000 in future services as his capital contribution. The following statement is inserted: “\$1,000 in cash; \$6,000 in future services—see schedule of services attached to this agreement as Attachment 1.” On a separate page, the following schedule of future services appears: “Attachment 1—Schedule of Future Services: Tom Chan will contribute a total of 300 hours of work for the LLC, for which he normally would be compensated at the hourly rate of \$20. This contributed work shall be performed between January 1, 20xx and June 30, 20xx, and shall consist of services of at least 12 hours per week during this period.”

- **Fair Market Value.** For noncash payments, show the fair market value of the property or services to be contributed. You may leave this item blank for cash payments.
- **Percentage Interest in LLC.** Here you specify the percentage interest each member will receive in return for his or her capital contribution. A member's interest should

be expressed as a percentage—for example, “50%.” A percentage interest—also referred to as the member’s capital interest—is the portion of the net assets of the LLC (total assets minus liabilities) that each member is entitled to when the business is sold or that is used to value a member’s interest when a member is bought out. To compute this percentage, see Instruction 12 above. This percentage interest figure is usually also used to determine other financial and managerial rights. For example, in our agreement, it is used to determine each member’s share of the LLC’s profit and loss, as well as members’ voting power in the LLC.

In most cases involving smaller LLCs, members will each put up a proportionate amount of cash for a membership interest—that is, a percentage interest in the LLC will normally equal a member’s proportionate cash capital contribution.

EXAMPLE 1:

Judy, Ed, and Sharon each contribute \$10,000 to their LLC to get it started, reasoning that \$30,000 is just about right to begin operations until enough cash starts to flow into the business to make it self-supporting. They each get a one-third (33⅓%) percentage interest in the LLC in return for their initial cash capital contributions.

EXAMPLE 2:

Gail and Lilian form their own LLC. Gail puts up \$10,000 in cash, plus a used computer system that will be signed over to the LLC for a fair market value of \$5,000. Lilian puts up \$7,500 in cash, plus signs over the pink slip to her paid-off Honda Accord with a middle blue book resale value of \$7,500. Each is given a 50% membership interest in the LLC.

EXAMPLE 3:

Sam and Jerry start an LLC. Sam has the cash, Jerry the expertise. Sam puts up \$75,000. Jerry agrees to forego his first \$25,000 in salary from the LLC as his capital contribution. Sam is given a 75% interest in the LLC, and Jerry is given a 25% interest. (In addition, Jerry will likely have to pay personal income taxes on the value of his LLC interest in the year the operating agreement is signed, as discussed in Chapter 3.)

How much, if any, extra documentation do you need to prepare to back up your capital contributions? In most cases, just filling in these blanks in your operating agreement to describe the type, value, and timing of each member’s payment will be enough. For instance, stating that a member will contribute future services worth \$10,000 to the LLC on or by a particular date, or that a member will pay \$10,000 to the LLC within three years of signing the agreement, plus interest at a specified (commercially reasonable) annual rate, will ordinarily make the other members comfortable. In some cases, you may feel the need to prepare additional documentation, such as a schedule of future services that describes when and what work a member will do for the LLC, or a promissory note that specifies the repayment terms of a future cash payment.

EXAMPLE 1:

Jeff will pay \$15,000 at a specified interest rate per the terms of a two-year note to buy a one-quarter stake in a new LLC. His capital contribution is described as follows:

<u>Name</u>	<u>Contribution</u>
Jeff Billings	\$15,000 per terms of note attached as Attachment 1
<u>Fair Market Value</u>	<u>Percentage Interest in LLC</u>
—	25%



RESOURCE

Use a promissory note for future cash payments. Make the note payable on demand after a certain date or number of months or years, or payable in equal or unequal installments during the term of the note. For simple promissory note forms to use for this purpose, see *Your Limited Liability Company: An Operating Manual*, by Anthony Mancuso (Nolo). Or you may wish to inventory and separately value various items of property that are being transferred by a member.

EXAMPLE 2:

Mary plans to contribute \$3,000 in cash and \$3,000 in property over the first year of a new LLC's life for her 40% share. Here's how she completes this provision:

<u>Name</u>	<u>Contribution</u>
Mary Ranier	\$3,000 in cash and \$3,000 in property as described on schedule attached as Attachment 2
<u>Fair Market Value</u>	<u>Percentage Interest in LLC</u>
\$6,000	40%

²⁶ This simple provision requires the unanimous vote of all members before members can be asked to contribute additional capital to the LLC. You may lower the vote requirement if you wish—for example, by specifying a majority vote (specifying a majority of members per capita or of percentage interests or profits interests), but if you do, be aware that some members may not be able to come up with the cash on time. What will you do then? Will you let the cash-rich members increase their percentage interests in the LLC while decreasing the percentage interests of the noncontributing members? This seems unfair, particularly to the members who want to contribute but can't come up with the

additional capital on time. Especially for small LLCs, this is the reason we think unanimity is best when it comes to additional contributions.

²⁷ This is a penalty provision for failure to pay contributions to the LLC on time. We don't address what "on time" means—it will follow the timelines established in your capital contributions clause unless you add language to this late payment provision specifying when its voting procedures kick in. For example, you may want this late payment provision to apply if a member fails to make a cash or property contribution within 30 days of its scheduled date. On the other hand, you may give a member who is to provide future services or make installment cash payments over the course of one or more years at least a month or two to remedy a missed installment payment before the late payment procedures go into effect.

You can also vary the penalty terms. Our provision requires a unanimous vote of remaining members to extend the terms for payment of a late capital contribution or terminate a delinquent member's membership. You may decide to require a lesser vote, eliminate entirely the procedure of terminating a membership for failure to pay a capital contribution on time, or make other changes or additions.

²⁸ It is standard not to pay interest to members on their capital contributions—after all, members are investing money in the business with the hope of making more money, not banking it.

Sample Operating Agreement for Member-Managed LLC (cont'd)

(2) Additional Contributions by Members: The members may agree, from time to time by unanimous vote, to require the payment of additional capital contributions by the members, on or by a mutually agreeable date. ²⁶

(3) Failure to Make Contributions: If a member fails to make a required capital contribution within the time agreed for a member's contribution, the remaining members may, by unanimous vote, agree to reschedule the time for payment of the capital contribution by the late-paying member, setting any additional repayment terms, such as a late payment penalty, rate of interest to be applied to the unpaid balance, or other monetary amount to be paid by the delinquent member, as the remaining members decide. Alternatively, the remaining members may, by unanimous vote, agree to cancel the membership of the delinquent member, provided any prior partial payments of capital made by the delinquent member are refunded by the LLC to the member promptly after the decision is made to terminate the membership of the delinquent member. ²⁷

(4) No Interest on Capital Contributions: No interest shall be paid on funds or property contributed as capital to this LLC, or on funds reflected in the capital accounts of the members. ²⁸

(5) Capital Account Bookkeeping: A capital account shall be set up and maintained on the books of the LLC for each member. It shall reflect each member's capital contribution to the LLC, increased by each member's share of profits in the LLC, decreased by each member's share of losses and expenses of the LLC, and adjusted as required in accordance with applicable provisions of the Internal Revenue Code and corresponding income tax regulations. ²⁹

(6) Consent to Capital Contribution Withdrawals and Distributions: Members shall not be allowed to withdraw any part of their capital contributions or to receive distributions, whether in property or cash, except as otherwise allowed by this agreement and, in any case, only if such withdrawal is made with the written consent of all members. ³⁰

(7) Allocations of Profits and Losses: No member shall be given priority or preference with respect to other members in obtaining a return of capital contributions, distributions or allocations of the income, gains, losses, deductions, credits, or other items of the LLC. The profits and losses of the LLC, and all items of its income, gain, loss, deduction, and credit shall be allocated to members according to each member's percentage interest in this LLC. ³¹

(8) Allocation and Distribution of Cash to Members: Cash from LLC business operations, as well as cash from a sale or other disposition of LLC capital assets, may be distributed from time to time to members in accordance with each member's percentage interest in the LLC, as may be decided by ["all" or "a majority"] of the members. ³²

(9) Allocation of Noncash Distributions: If proceeds consist of property other than cash, the members shall decide the value of the property and allocate such value among the members in accordance with each member's percentage interest in the LLC. If such noncash proceeds are later reduced to cash, such cash may be distributed among the members as otherwise provided in this agreement. ³³

If, however, you wish to pay interest on members' capital contributions, you should delete this paragraph and provide for interest payments instead. You can make a general authorization, which lets members pin down the terms of the interest payments later by themselves, or spell out the terms—such as interest rate, dates, and manner of payment:

Sample Language: Interest on Capital Contributions: Interest shall be paid on funds or property contributed as capital to this LLC or on funds reflected in the capital accounts of the members ["as may be agreed by unanimous vote of the members" or specify terms (interest rate, dates, and manner of payment)].

²⁹ This tax language requires the LLC to set up capital accounts for each member, something that is required for federal income tax purposes. We state general rules here for LLC capital account bookkeeping. We don't cite specific sections of the Internal Revenue Code that may affect your LLC's bookkeeping or lay out all the special provisions that may apply to setting up and maintaining LLC capital accounts.

As discussed in Chapter 3, if you decide to make special allocations of profits and losses, you (and your tax adviser) may decide to include additional language to make sure your allocations of profits and losses will go unchallenged by the IRS.

³⁰ This provision reflects a standard practice of not allowing withdrawals of capital by LLC members prior to a dissolution of the company, unless approved in writing by all members. You can change this provision to allow premature withdrawals of capital in certain instances or with the consent of fewer than all members. For example, you may want to give yourself and the other members flexibility to withdraw part of the cash balance from positive capital accounts

in times of personal financial emergency with less than unanimous membership consent as long as the LLC remains solvent and able to pay its bills. Your tax adviser can help you draft custom provisions of this sort.

³¹ This paragraph makes it clear that all members have equal participation rights in the profits and losses of the LLC. The last sentence specifies that members will share in LLC profits and losses in accordance with their respective percentage interests in the business—the most common arrangement for smaller LLCs. These percentages, in turn, are established by the capital contributions listed in “IV. Capital Provisions: (1) Capital Contributions by Members” (the first paragraph of this section of the agreement) and “II. Membership Provisions: (4) Members' Percentage Interests” (the fourth paragraph of Section II).

As we've mentioned earlier, we think most smaller LLCs will not need or benefit by adopting disproportionate profit or loss provisions. But if you have special needs and your tax adviser concurs, replace this paragraph with special provisions of your own. For example, you may wish to give a member who contributes \$25,000 in cash as capital a greater share of LLC profits than a member who promises to contribute \$25,000 over the course of three years. Again, see Chapter 3 and consult your tax adviser to make sure any disproportionate allocations of profits will comply with IRS rules (discussed in Chapter 3).

EXAMPLE:

Dwayne, Blaine, and Jane agree to allocate their LLC profits and losses disproportionately. They change this paragraph to read: “No member shall be given priority or preference with respect to other members in obtaining a return of capital contributions, distributions, or allocations of the income,

gains, losses, deductions, credits, or other items of the LLC. Items of its income, gain, loss, deduction, and credit shall be allocated to members according to each member's percentage interest in this LLC, except as follows: [Here they specify any special (disproportionate) allocations of profits, losses, and any other items to particular members. Their tax adviser adds additional language to have these special allocations respected by the IRS.]

Here are other changes you can make to this provision (again, get help from your tax adviser):

- You can adopt multiclass membership provisions, with some members being first in line to receive a return of their capital investment.
- You can decide that some LLC members will be entitled to their share of profits and losses (disproportionate or otherwise) before all other members and shall continue to receive the only distributions of LLC profits until they have been paid back their initial capital contribution. The following sample provision, or one similar to it, will accomplish this.

Sample Language: Allocations of Profits and Losses: Notwithstanding any other provision in this agreement, the following members, called "priority members," shall receive all distributions of the LLC's profits and losses before any distributions are made to any other members of the LLC: [list priority members]. Further, the other members of the LLC shall not receive any distributions until each of these priority members has received total distributions equal to each priority member's initial capital contribution to the LLC.

32 This provision gives members leeway to distribute cash profits or proceeds of the LLC

to members if they vote to do so. Most smaller LLCs will require a unanimous vote, but some may prefer to allow just a majority of the membership to decide this issue—remember, a majority of members is defined earlier in this agreement ("II. Membership Provisions: (5) Membership Voting") as a majority of the percentage interests in the LLC.

Again, we assume that allocations of profits and losses will follow each member's percentage interest in the LLC, but you can vary who gets how much if you (and your tax adviser) decide to implement disproportionate (special) allocations of LLC profits.

33 This paragraph addresses how any non-cash LLC property will be allocated among members. Basically, property gets allocated among the members in proportion to each member's percentage interest in the LLC. If reduced to cash later, it will be distributed to members according to an earlier provision in this operating agreement ("IV. Capital Provisions: (8) Allocation and Distribution of Cash to Members").

EXAMPLE:

Second-Hand Freight and Salvage, Ltd. Liability Co., a five-member company, decides to sell a truck and allocate the current value of this asset to the members, who own the LLC in equal percentages. The truck is worth \$30,000, so the capital account of each member is increased by \$6,000. The members can vote to distribute this cash according to the cash distribution provision in their agreement.

34 This paragraph sets up a special rule to handle a distribution of the cash and other assets of the LLC when the business itself liquidates or when a member's interest is liquidated. It applies the distribution to each

member's capital account, then allows for credits and deductions that may need to be made prior to a final distribution. A final distribution is then made to members with positive account balances.

V. Membership Withdrawal and Transfer Provisions

This section covers members deciding to leave the LLC and restrictions on the transfer of membership.

35 This is a liberal provision that lets a member bow out from the LLC by giving prescribed written notice. The period required is up to you—you can allow a quick departure, say in 30 days, or require many months' prior written notice. A typical advance notice period mentioned in LLC statutes is 180 days.

If you want, you may modify this provision. For example, you may choose to limit the circumstances under which members may withdraw, or you may want to assess a monetary penalty if a member leaves too soon. One way is to limit the price for a member's interest under mandatory buy-sell, or buyout, provisions in your agreement. We don't include buy-sell provisions of this sort in our simple agreement so you'll need to consult a lawyer or tax adviser. Or, see *Business Buyout Agreements: Plan Now for Retirement, Death, Divorce or Owner Disagreements*, by Bethany Laurence and Anthony Mancuso (Nolo), for instructions and buyout provisions for your operating agreement.



CAUTION

Be careful if you decide to specify a substantial monetary penalty for leaving the LLC too soon. Courts may not enforce limitations placed on individuals' abilities to come into and go out of a business freely if they believe the limitations unduly restrict an individual's right to transfer an

LLC interest or compete freely in the marketplace. Besides, lawyers love to sue, and your departing member may hook up with a litigious lawyer (or vice versa) upon leaving your LLC.

There are other issues you may want to address in this provision—for example, what happens if a “service member” leaves the business before fully performing services promised in return for a share in the LLC.

EXAMPLE:

John received a 15% share in Fast Fries LLC in return for a promise to perform \$15,000 worth of services for the LLC over a two-year period. However, John leaves prior to completing these promised capital contributions; when he gives notice of withdrawal, he has only worked off \$7,500. Can John be forced to report to work for the LLC even though he is no longer a member? No—a court simply won't enforce this requirement. In short, if John is determined to leave, there is no legal remedy available to force him to keep working off his capital contribution.

The simple solution is to require departing “service members” to pay off in cash the amount of services left undone. This can be paid by way of a set-off against the departing member's capital account, with the member's agreeing to pay any deficiency in cash or over time according to the terms of a promissory note.

Sample Language: If any member leaves this LLC prior to fully performing services promised as part of the member's capital contribution, his or her capital account shall be debited in an amount equal to the dollar amount of the value of the unpaid services prior to a distribution of any capital account

Sample Operating Agreement for Member-Managed LLC (cont'd)

(10) Allocation and Distribution of Liquidation Proceeds: Regardless of any other provision in this agreement, if there is a distribution in liquidation of this LLC, or when any member's interest is liquidated, all items of income and loss shall be allocated to the members' capital accounts, and all appropriate credits and deductions shall then be made to these capital accounts before any final distribution is made. A final distribution shall be made to members only to the extent of, and in proportion to, any positive balance in each member's capital account. ³⁴

V. Membership Withdrawal and Transfer Provisions

[These provisions deal with members' decision to leave the LLC and transfer their interest to someone new. We specifically require a unanimous vote to admit a transferee (someone who buys or is otherwise transferred an LLC interest from a member) as a new member of the LLC. Some states impose mandatory membership vote requirements to admit transferees into membership. Our transfer restriction language below is intended to help you meet the most stringent of any such rules in effect in your state. See your state's LLC act if you want to know your state's rule.]

(1) Withdrawal of Members: A member may withdraw from this LLC by giving written notice to all other members at least [number of days] days before the date the withdrawal is to be effective. ³⁵

(2) Restrictions on the Transfer of Membership: A member shall not transfer his or her membership in the LLC unless all nontransferring members in the LLC first agree to approve the admission of the transferee into this LLC. Further, no member may encumber a part or all of his or her membership in the LLC by mortgage, pledge, granting of a security interest, lien, or otherwise, unless the encumbrance has first been approved in writing by all other members of the LLC. ³⁶

Notwithstanding the above provision, any member shall be allowed to assign an economic interest in his or her membership to another person without the approval of the other members. Such an assignment shall not include a transfer of the member's voting or management rights in this LLC, and the assignee shall not become a member of the LLC. ³⁷

balance to the member. If the capital account balance prior to this deduction is less than the full amount of the value of the unperformed services, the amount of the value of the unperformed services that exceeds the positive capital account balance of the member shall be paid by the departing member as follows: [specify terms of repayment of any deficiency, for example “in cash within 30 days of departure of the member from the LLC” or “in accordance with the terms of a promissory note payable to the LLC by the departing member, the principal amount of which shall be the value of the unperformed services that were not satisfied from the member’s positive capital account balance upon his or her departure from the LLC”] .

EXAMPLE:

Part of Sam’s contribution to Sam & Pam’s Sandblasting & Plastering LLC is a promise to perform future services worth \$10,000. The LLC operating agreement requires departing service members to convert any unperformed services to a promissory note if they leave the LLC prior to performing all promised services. Sam decides to leave the LLC when he still owes \$5,000, and his capital account balance is at \$2,000. When he departs, Sam will either be required to pay the remaining \$3,000 (the amount he still owes reduced by his capital account balance) in cash or under the terms of a promissory note that he signs in favor of the LLC.

For departing members who received a share in the LLC in return for a promise to pay off a note on which they still owe money, you may choose to do nothing. Because these people are still legally bound to pay off the note, you can simply let them leave (not try to renegotiate the note or convert it to a lump-sum payment).

You may, however, decide that any type of long-distance or extended payoff would be too tenuous or uncomfortable after a member leaves the business. Accordingly, you may wish to add language here requiring all persons who owe money on their initial capital contribution to make a lump-sum cash payment to the LLC equal to the amount of the unpaid capital contribution at the time of their withdrawal from the LLC.

Sample Language: If a member departs this LLC prior to full payment of his or her capital contribution, whether the unpaid capital contribution consists of cash, payments under a promissory note, the performance of future services, or the transfer of property, the member shall be bound to pay a lump sum to the LLC at the time of his or her departure equal to the amount of the unpaid cash, amount of the unpaid principal and interest under the note, value of unperformed services, or the value of the untransferred property. The lump sum shall be paid to this LLC no later than [number of days] days after the departing member leaves the LLC, and payment of the lump sum within this period shall extinguish the liability of the departing member for the amount or value of his or her unpaid capital contribution to this LLC.

Our above examples and sample provisions are suggestions only. The best way to anticipate and come to terms with handling unpaid capital contributions upon the departure of a member is to talk with all members and your tax adviser (particularly if you plan to tinker with the capital account balance of a departing member). Reaching this kind of informed consensus before you add any language to your operating agreement helps avoid bad feelings and uncooperative behavior later—when, for example, a departing member complains he or she wasn’t in on the discussions on how

Sample Operating Agreement for Member-Managed LLC (cont'd)

VI. Dissolution Provisions

[This section addresses the dissolution of the LLC, or events that may trigger a dissolution. In Section 1(a), we specifically require the vote of all remaining members to continue the business of the LLC after a member is dissociated (loses his or her membership interest). Most states typically do not require a vote in such cases, but we think it is sensible in a smaller LLC to make sure all remaining members want to carry on the business of the LLC after a member leaves or is otherwise dissociated from the LLC. See your state's LLC act if you want to know your state's rules.]

(1) Events That Trigger Dissolution of the LLC: The following events shall trigger a dissolution of the LLC, except as provided:

- (a) the death, incapacity, bankruptcy, retirement, resignation, or expulsion of a member, except that within [number of days (typically a maximum of 90 under remaining state LLC default rules)] of the happening of any of these events, all remaining members of the LLC may vote to continue the legal existence of the LLC, in which case the LLC shall not dissolve ³⁸
- (b) the expiration of the term of existence of the LLC if such term is specified in the articles of organization, certificate of formation, or a similar organizational document, or this operating agreement ³⁹
- (c) the written agreement of all members to dissolve the LLC ⁴⁰
- (d) entry of a decree of dissolution of the LLC under state law. ⁴¹

VII. General Provisions

[These provisions cover general items concerning operation of the LLC. You'll also find standard provisions, normally found at the end of LLC agreements, dealing with the enforceability of the agreement.]

(1) Officers: The LLC may designate one or more officers, such as a president, vice president, secretary, and treasurer. Persons who fill these positions need not be members of the LLC. Such positions may be compensated or noncompensated according to the nature and extent of the services rendered for the LLC as a part of the duties of each office. Ministerial services only as a part of any officer position will normally not be compensated, such as the performance of officer duties specified in this agreement, but any officer may be reimbursed by the LLC for out-of-pocket expenses paid by the officer in carrying out the duties of his or her office. ⁴²

(2) Records: The LLC shall keep at its principal business address a copy of all proceedings of membership meetings, as well as books of account of the LLC's financial transactions. A list of the names and addresses of the current membership of the LLC also shall be maintained at this address, with notations on any transfers of members' interests to nonmembers or persons being admitted into membership in the LLC.

unpaid contributions would be handled when a member leaves, and therefore didn't realize being let out of the LLC meant having to pay cash.

This operating agreement provision deals only with a member's packing up and quitting the LLC. It does not address the selling of LLC interest to a new member—we deal with this latter issue in the next provision in the agreement titled “Restrictions on the Transfer of Membership.”

³⁶ This provision is intended to satisfy any requirements in your state's LLC act that require member approval of nontransferring members when a member wishes to transfer membership to a new member.

This provision requires the approval of *all* nontransferring members to the sale of membership interests to a new member. This requirement should not only meet any requirement still found in your state's LLC act, but also helps protect your members from having to admit an incompatible person as a new member of your LLC. After all, the new member will have to get along and work closely with the other members. If any member doesn't like or is incompatible with the new member, the LLC's business may suffer significantly and the personal enjoyment the members derive from working together may be lost.

If you wish to alter this provision to allow just a majority (or other lesser number) of nontransferring members to approve the sale of a membership to a new member, make sure your state lets you adopt the lesser membership vote rule you have in mind. Check your state LLC act to find out.

Finally, note that this paragraph requires all members to agree before a member encumbers a membership, such as by putting it up as collateral for a loan or pledging it as security for the performance of some other legal obliga-

tion. You can lessen the vote requirement for encumbrances, but we think unanimous written approval works best here too.

³⁷ This paragraph states an exception to requiring unanimous approval of transfers of interest, which is recognized under state statutes. Namely, even in states that still require membership approval of a transfer of membership, a member is allowed to transfer *economic interests in a membership* without the approval of the nontransferring members. As long as the person getting the interest—the assignee or transferee—does not become a new member with management and voting rights, the transfer is of an economic interest only, and does not require membership approval under state law.

EXAMPLE:

Katherine owns a one-third interest in a lucrative LLC. She assigns one-quarter of her profits interest in her LLC to a trust set up for the benefit of her niece, Brenda. This transfer of economic rights only is not restricted under state law.

Of course, you can decide not to permit even these transfers of economic interests by members, simply by deleting this paragraph. (By the way, you don't need to be overly concerned about the possibility of outsiders buying an economic interest in your LLC—there generally is little interest by outsiders in buying a profits-only interest in an LLC without full membership rights.)

VI. Dissolution Provisions

This section covers dissolution of the LLC.

³⁸ This provision covers what will happen when a member's interest in the LLC is terminated—legally, when a member is *dissociated*—because the member resigns,

retires, dies, is permanently incapacitated, goes bankrupt, or is subject to any of the other conditions listed here. Some states may require a membership vote to continue the legal existence of the LLC after a member is dissociated.

Our provision requires the vote of all remaining LLC members to continue the legal life of your LLC after a member withdraws, sells his or her interest, becomes incapacitated, dies, or is expelled. This unanimous vote requirement satisfies the most stringent of any legal requirements on this point on the books in a few states. We're sure you'll find it easy to comply with, too—just meet with the remaining LLC members and ask if everyone is in agreement that the business of your LLC should continue without the dissociated member. With rare exceptions, everyone should agree (if someone doesn't, you will want to rethink your LLC business anyway, perhaps deciding to buy out the protesting member before continuing on with LLC business).

Notice that you must fill in the blank in our provision to specify the deadline for voting to continue the legal existence of the LLC after the occurrence of a dissolution-triggering event. We think “90 days” makes sense. You can always vote any time before the 90-day deadline (the language says “within [number of days]” of the happening of one of the membership terminating events). If, however, you want to insert a shorter period, we suggest specifying no fewer than 30 days to give your members a chance to meet and approve the continuance of your LLC.

³⁹ A few states require the articles of organization to limit the legal existence of the LLC to a specified term of years or until a particular date. This provision simply states that the LLC will dissolve if a termination date or period is specified in the articles of organization or this

operating agreement. (See our earlier discussion on filling in “I. Preliminary Provisions: (6) Duration of LLC,” in Special Instruction ⁸, above.)

⁴⁰ Your LLC may decide to call it quits at any time by the unanimous approval of all members to dissolve. We think this makes sense—and most LLC owners wouldn't want it any other way. (In fact, most state LLC laws say you can do this even if your operating agreement doesn't specify it.)

⁴¹ State statutes may provide for the involuntary dissolution of an LLC should the members reach an impasse or in the case of fraud, illegality, or nonpayment of state taxes. This provision simply recognizes that the LLC may dissolve by order of a state court.

VII. General Provisions

This section covers general items regarding the operation of the LLC, such as officers and records.

⁴² This paragraph allows, but does not require, the LLC to appoint one or more persons as officers of the LLC, who may be members or nonmembers. Some state LLC statutes mention the officer positions of president, vice president, secretary, and treasurer, but even those states don't require that the positions be filled or define the job duties and responsibilities of these offices.

We suggest you not worry too much about specific officer titles (“Treasurer” vs. “Chief Financial Officer” vs. “Chief Poobah in Charge of Payroll”). Pay attention instead to making sure each LLC employee knows the scope and responsibilities of his or her position with your LLC, whether it is as a formal officer or in a regular staff position.

Feel free to modify this provision to have it reflect how you want to handle the designation and compensation of any officers in your LLC.

Sample Operating Agreement for Member-Managed LLC (cont'd)

Copies of the LLC's articles of organization, certificate of formation, or a similar organizational document, a signed copy of this operating agreement, and the LLC's tax returns for the preceding three tax years shall be kept at the principal business address of the LLC. A statement also shall be kept at this address containing any of the following information that is applicable to this LLC:

- the amount of cash or a description and value of property contributed or agreed to be contributed as capital to the LLC by each member
- a schedule showing when any additional capital contributions are to be made by members to this LLC
- a statement or schedule, if appropriate, showing the rights of members to receive distributions representing a return of part or all of members' capital contributions, and
- a description of, or date when, the legal existence of the LLC will terminate under provisions in the LLC's articles of organization, certificate of formation, or a similar organizational document, or this operating agreement.

If one or more of the above items is included or listed in this operating agreement, it will be sufficient to keep a copy of this agreement at the principal business address of the LLC without having to prepare and keep a separate record of such item or items at this address.

Any member may inspect any and all records maintained by the LLC upon reasonable notice to the LLC. Copying of the LLC's records by members is allowed, but copying costs shall be paid for by the requesting member. ⁴³

(3) All Necessary Acts: The members and officers of this LLC are authorized to perform all acts necessary to perfect the organization of this LLC and to carry out its business operations expeditiously and efficiently. The Secretary of the LLC, or other officers, or all members of the LLC, may certify to other businesses, financial institutions, and individuals as to the authority of one or more members or officers of this LLC to transact specific items of business on behalf of the LLC. ⁴⁴

(4) Mediation and Arbitration of Disputes Among Members: In any dispute over the provisions of this operating agreement and in other disputes among the members, if the members cannot resolve the dispute to their mutual satisfaction, the matter shall be submitted to mediation. The terms and procedure for mediation shall be arranged by the parties to the dispute.

If good-faith mediation of a dispute proves impossible or if an agreed-upon mediation outcome cannot be obtained by the members who are parties to the dispute, the dispute may be submitted to arbitration in accordance with the rules of the American Arbitration Association. Any party may commence arbitration of the dispute by sending a written request for arbitration to all other parties to the dispute. The request shall state the nature of the dispute to be resolved by arbitration, and, if all parties to the dispute agree to arbitration, arbitration shall be commenced as soon as practical after such parties receive a copy of the written request.

We suggest not being too specific, to allow maximum leeway to appoint various types of LLC salaried and nonsalaried officers and personnel. You do not need to say that your LLC has the power to hire employees and compensate them for their services; this type of employment authority goes without saying.

43 Your state LLC statute may allow you to restrict when or why members are allowed to look at LLC records or access particular types of LLC legal or financial records. We don't nitpick here, and simply give all members an unrestricted right to view all records at any time. If you want to restrict member inspection rights, first take a look at your state LLC statute for any limits or rules on this.

Sample Language: Any member may inspect the financial or other records of this LLC for a purpose reasonably related to the member's interest in this LLC. The Treasurer of this LLC shall make the determination within one week of the member's request and, if the Treasurer finds that the member's request is related to his or her interest in the LLC, the requesting member shall be allowed to inspect the records during regular business hours of the LLC at its principal place of business.

44 This housekeeping provision says that the secretary of the LLC or other LLC officers or its members may sign a statement that certifies to other businesses or outside persons the capacity of one or more LLC members or officers to engage in particular business on behalf of the LLC. A bank, escrow, or title company, or other outside person or business may wish to obtain a statement certifying such authority prior to entering into a contract or business transaction with an LLC member or officer. (We provide a Certification of Authority form to use for this purpose, in Chapter 7; a blank form is also provided in Appendix B and on the CD-ROM.)

45 Mediation, followed if necessary by arbitration, is usually a quicker and less expensive way to settle disputes than litigation—for example, arguments over the valuation of LLC interests incident to a buyout or disagreements over who gets to use the LLC's name after the business is formally dissolved.

This bare-bones provision says unresolved disputes among LLC members should first be submitted to mediation. Mediation is a voluntary, nonbinding process in which an impartial mediator tries to get the parties to agree to a settlement. (For an excellent, in-depth coverage of the mediation process, see *Mediate, Don't Litigate: Strategies for Successful Mediation*, by Peter Lovenheim and Lisa Guerin, available as an eBook only at www.nolo.com.)

In our provision, if mediation cannot be undertaken or is unsuccessful, the dispute may be submitted to binding arbitration by the parties. Even this procedure—an out-of-court, informal hearing before an impartial arbitrator that produces a legally enforceable decision—is both quicker and less expensive than going to court.

You may want to make some minor changes, such as choosing a different association as a model for the arbitration rules, requiring three arbitrators instead of one (opposing sides of a dispute each pick one arbitrator, and these two arbitrators pick a third), and other changes you deem appropriate.

46 This is a boilerplate legal provision that negates any prior agreements among the members, whether oral or written. This can be important because the general rule is that LLCs, like partnerships, may legally be based on oral agreements.

This provision also requires future changes to the agreement, or the adoption of a new operating agreement, to be signed by all

Sample Operating Agreement for Member-Managed LLC (cont'd)

All parties shall initially share the cost of arbitration, but the prevailing party or parties may be awarded attorney fees, costs, and other expenses of arbitration. All arbitration decisions shall be final, binding, and conclusive on all the parties to arbitration, and legal judgment may be entered based upon such decision in accordance with applicable law in any court having jurisdiction to do so. ⁴⁵

(5) Entire Agreement: This operating agreement represents the entire agreement among the members of this LLC, and it shall not be amended, modified, or replaced except by a written instrument executed by all the parties to this agreement who are current members of this LLC as well as any and all additional parties who became members of this LLC after the adoption of this agreement. This agreement replaces and supersedes all prior written and oral agreements among any and all members of this LLC. ⁴⁶

(6) Severability: If any provision of this agreement is determined by a court or arbitrator to be invalid, unenforceable, or otherwise ineffective, that provision shall be severed from the rest of this agreement, and the remaining provisions shall remain in effect and enforceable. ⁴⁷

VIII. Signatures of Members and Spouses

[The final section of the agreement contains signature lines for the members, plus a series of lines for their spouses to sign.]

(1) Execution of Agreement: In witness whereof, the members of this LLC sign and adopt this agreement as the operating agreement of this LLC.

Date: _____ ⁴⁸

Signature: _____

Printed Name: _____, Member

Date: _____

Signature: _____

Printed Name: _____, Member

Date: _____

Signature: _____

Printed Name: _____, Member

Date: _____

Signature: _____

Printed Name: _____, Member

Sample Operating Agreement for Member-Managed LLC (cont'd)

(2) **Consent of Spouses:** The undersigned are spouses of the members of this LLC who have signed this operating agreement in the preceding provision. These spouses have read this agreement and agree to be bound by its terms in any matter in which they have a financial interest, including restrictions on the transfer of memberships and the terms under which memberships in this LLC may be sold or otherwise transferred. 49

Date: _____

Signature: _____

Printed Name: _____

Spouse of: _____

Date: _____

Signature: _____

Printed Name: _____

Spouse of: _____

Date: _____

Signature: _____

Printed Name: _____

Spouse of: _____

Date: _____

Signature: _____

Printed Name: _____

Spouse of: _____

original parties to the agreement who are current members of the LLC, plus any new members. You can change this provision to allow less than unanimous approval of operating agreement changes, but we think these changes are usually important enough to warrant unanimous approval of all current members. (We cover how to amend your operating agreement in Chapter 7.)

47 This is a standard legal provision that directs a court or arbitrator to enforce the balance of the agreement even if one or more provisions are held invalid, ambiguous, or otherwise unenforceable.

VIII. Signature of Members and Spouses

This section includes signature lines for the members and their spouses.

48 Before the members sign the agreement, have them initial crossed-out language and changes that were made to the agreement, if any. (However, they don't need to initial filled-in lines.)

Have each member date and sign the operating agreement. Type or print the name of each member under the corresponding signature line, after the words "Printed Name." Make sure each member signs the operating agreement.



SEE AN EXPERT

Get sign-off from a tax adviser. Before you sign your final agreement, let your tax adviser review your choices, particularly those related to the financial (capital) provisions and tax options (for example, whether to have your LLC taxed as a pass-through entity or as a corporation, and whether to require minimum payouts of a percentage of profits each year to help members pay income taxes they owe on LLC profits allocated to them at the end of the year).

49 This standard provision shows spousal consent to the provisions of the operating agreement. We strongly suggest that each married LLC member have his or her spouse date and sign on one of the sets of lines following this spousal consent provision. Doing this can help avoid disputes later, should spouses separate, divorce, or die, or should one spouse decide to sell or transfer his or her membership in the LLC.



SEE AN EXPERT

Leaving interests by means of estate planning devices. You may add provisions that permit spouses of members to use a will or other estate planning device, such as a living trust, to leave their half- or other co-interest in an LLC membership to outsiders. See your tax or legal adviser for guidance if you wish to address issues of this sort in your agreement.

See an Expert for Adding Special Capital Account Provisions or Buy-Sell Provisions to Your Operating Agreement

There are two major areas of LLC operations that our agreements do not cover.

Special Capital Account Provisions

Capital account provisions set forth the types and amounts of capital contributed by your original members (see Section IV. Capital Provisions of the sample operating agreement, above). If you read a lawyer- or accountant-prepared LLC operating agreement, you'll usually see lists of complicated capital account definitions and provisions (language that specifies how members' capital contributions and distributions are to be handled under a range of circumstances). This special language can be important if you decide to split profits and losses among your LLC members in ratios that are different from the percentage of capital each member contributes to your LLC. (For a fuller discussion of this issue, see Chapter 3.)

For our purposes, and for most readers of this book, adding special provisions to handle these "special allocations" of profits and losses is not necessary, so we do not include them in our sample operating agreements. If you think you'd like to include special allocation provisions in your operating agreement, ask your tax adviser and lawyer for help.



SEE AN EXPERT

Consider getting help drafting other special financial provisions. A legal or tax adviser can also help you prepare special financial provisions of any sort—for example, to set up a special class of membership that gets a guaranteed share of LLC profits or losses or to establish a special schedule for distribution of LLC profits to members before liquidation.

Buy-Sell Provisions

An important and sometimes complicated aspect of forming any business is deciding what happens when a member wants to sell his or her interest. Here are some examples of the kinds of issues that may arise:

- **"Right of first refusal" issues.** Does an owner who wishes to sell out have to offer to sell his or her interest to the other owners before selling to an outsider? Must the other owners buy that interest for the amount an outsider is ready to pay?
- **Valuation questions.** When a member (or the member's estate) wishes to sell to other members, how will the interest be valued? Should an appraiser resolve this issue at the time of sale? Or should the value of membership interests be established ahead of time in the LLC operating agreement—if so, should the value be based upon the book (net asset) value of the business, a multiple of the earnings of the business, or some other formula?
- **When and how should a departing LLC member who is being bought out be paid?** Should payment be made all in a lump sum or in installments? This is an important question, because your LLC or its other members may not have sufficient cash or borrowing power to come up with the needed buyout funds right away. On the other hand, a departing LLC member (or the member's estate) will want to be paid as soon as possible. If the buyout is paid in installments, should the LLC be charged interest?

See an Expert for Adding Special Capital Account Provisions or Buy-Sell Provisions to Your Operating Agreement (cont'd)

- **Life insurance.** Should the buyout of a deceased owner be funded with life insurance purchased ahead of time by the LLC or each of the other members?
- **Does it matter why or when a member is being bought out?** For example, if a member calls it quits and wishes to transfer his or her interest back to the LLC after only six months with the LLC, should that member receive a smaller buyback price than a member who stays with the LLC for five years? What about a member who is expelled? What about a member who suffers a debilitating illness or dies?

Most businesses decide to tackle these issues down the road. They reason that, for now, it's enough to know that an appraiser can be called in to establish a fair value of a member's interests if a member wishes to sell out. (You don't even need to say this in your operating agreement; you can just call in an appraiser when the time comes.) Our operating

agreements do include basic transfer restrictions, which may be adequate, at least in the short term. These transfer restrictions require the approval of all or a majority of the nontransferring members before admitting a new person as a member in the LLC.

However, other detail-oriented business owners decide to ask and answer all these questions and spell out their conclusions as part of the membership restrictions in their initial operating agreement. If you decide to go the extra distance and include buy-sell or buyout provisions in your initial operating agreement, you can ask your LLC legal adviser to put together provisions that will work for you. Alternately, you can consult Nolo's book *Business Buyout Agreements: Plan Now for Retirement, Death, Divorce or Owner Disagreements*, by Bethany Laurence and Anthony Mancuso, which provides step-by-step instructions and forms for preparing your buy-sell, or buyout, provisions.

Distribute Copies of Your Operating Agreement

Congratulations! You are done with another important organizational task, and your LLC is well on its legal way. Make photocopies of the completed, signed operating agreement and give each member a copy. Finally, place the original, signed operating agreement in your LLC records book, along with other important documents. ●

Prepare an LLC Operating Agreement for Managers

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Some LLCs wish to set up a special management structure that does not consist of all LLC members. The management team may be made up of:

- some, but not all, LLC members
- both outside managers and some LLC members, or
- only outside managers.

If your LLC is structured in one of these ways, you have a manager-managed LLC. We'll show you how to prepare an operating agreement here. We assume you are in the process of forming, or have already formed, your LLC by preparing and filing articles of organization with your state LLC filing office, as explained in Chapter 4.



SKIP AHEAD

If yours is a member-managed LLC, turn to Chapter 5. In Chapter 5, we cover the first LLC operating agreement contained in Appendix B, which provides for management of the LLC by all members. If you're unsure which agreement you need, read on.

Choosing a Manager-Managed LLC

Although most smaller LLCs will choose to be managed by all members, a minority will find a manager-managed LLC more suitable. LLCs that decide on manager-management usually do so for one or both of these reasons:

- At least one member wishes to be a “passive” investor and to hand over the reins and responsibilities of management to others.

EXAMPLE:

Sole Sisters is a shoe design and distribution partnership owned and operated by three sisters, Julie, Laurie,

and Ginny. Ginny contributed the cash to get the partnership started, leaving all business management and day-to-day operations to Julie and Laurie, whose capital contributions are portions of their past (unpaid) services performed for the partnership. All three sisters decide that converting the business to an LLC makes sense, but they wish to keep the same management arrangement among themselves. What's the solution? Simple. They decide to adopt a manager-management agreement—the kind discussed in this chapter—with Julie and Laurie designated as the managers of the LLC. Ginny will be a nonmanaging member, thus avoiding all management responsibilities.

- The members believe that the LLC will be handled better by outsiders (nonmembers) who have special expertise in managing the business.

EXAMPLE:

Power-Packed Peanut Products LLC (PPPP), a food wholesaler, is formed and funded by Tina and Kay, entrepreneurs with an eye for a promising business venture, but with little expertise or interest in managing or running it on a day-to-day basis. They decide to shell out substantial salaries to experienced food wholesalers Jason and Charlotte, who will manage and run the business as its nonmember managers. Jason and Charlotte bring years of prior experience to the newly formed business, having just sold their co-owned food distribution business, J&C Wholesalers, at a substantial profit. They are ready to get involved growing another successful company in exchange for chunky salaries on PPPP's payroll.

Limited Liability for All Members of Manager-Managed LLC

In their roles as LLC members, all members—whether managing or nonmanaging—qualify for personal legal immunity from business debts and legal claims made by outsiders against the LLC.

Limited Liability for Managers of Manager-Managed LLC

State law may impose slightly stricter standards on LLC managers (regardless of whether they're also members). That is, managers will receive the normal personal immunity from business debts and liabilities that the LLC provides, but they may suffer exposure to personal liability if they participate in making exceptionally bad or illegal business decisions in their roles as managers.

Don't get too concerned here if you plan to be an LLC manager. The circumstances where a manager may be found personally liable are the exceptions, not the rule. Circumstances that breed such personal liability tend to involve decisions that are self-interested (where a manager takes personal advantage of a business deal with the LLC without proper disclosure of his or her interest) or situations where the manager acts in an extremely reckless or illegal manner.

EXAMPLE 1:

Suits of Amoré, LLC, a haberdasher of formal men's attire for weddings, parties, and other black-tie affairs, is on the lookout for top-quality Italian suits it can offer its customers. In the course of his research, Fredo, an LLC manager, spots a phenomenal opportunity to purchase top-of-the-line Santoro suits (normally \$2,500 plus retail per unit) at an unheard of discount. He

decides to cash out his personal bank account savings and buy up the suits, rather than mention his find to the other LLC managers, who would jump at the chance to acquire the merchandise. Fredo will find a private buyer for the suits. If another LLC manager gets wind of Fredo's find, and the LLC sues him for lost profits—the amount the LLC could have made had it been allowed to buy and resell the suits—a court would likely find Fredo personally liable. The normal rule is that a manager has a duty of loyalty to disclose opportunities discovered in the course of his or her work that might benefit the business (unless it is obvious that the business would have no interest in the opportunity); only after the business decides not to act is the manager allowed to go ahead and personally pursue the opportunity.

EXAMPLE 2:

The managers of Lowball Construction Ltd. Liability Co. are warned repeatedly by the VP of operations that an electrical panel box installation being performed by the company at one of its worksites is not up to code. The LLC managers disregard his advice to order the substandard work to be redone, insisting that the company can't afford to miss another performance deadline under its contract with the owner of the building. After Lowball completes the installations, the owner rents the building to a computer manufacturer, which moves in and sets up sensitive electronic measurement and test equipment it uses in its operation. When the computer firm flips the switch to fire up its equipment, a short circuit due to faulty ground wiring in the service panel box sends a voltage spike through the outlets on the circuit—and destroys all the computer maker's expensive test equipment. The

building owner is sued for the loss, and she immediately sues Lowball and its managers. Lowball's lawyer advises the managers that it is unlikely that their commercial insurance carrier will cover this loss—the electrical panel box at fault was never inspected and approved by the local building inspector. The managers may be held personally liable for the loss due to their gross negligence in not heeding the warnings of their VP to redo the faulty service panel wiring.

Of course, these are extreme examples, mostly used to make the following points. First, the LLC will protect you and your comanagers personally for normal negligence—the kind of business judgment errors humans without 20-20 foresight may make. But don't be lulled into an unassailable sense of security by the normal limited liability protection afforded by the LLC form. If you engage in truly foolish conduct that is obviously reckless to the safety of other people or their property, or you act illegally or underhandedly in your own self-interest, then the mantle of personal protection that your LLC normally provides may be lifted. In that case, you and the other LLC managers will be exposed to personal liability for the reckless or illegal decisions.



TIP

Provide managers with indemnification and/or insurance. If you want to attract outside managers to help run your LLC, you may need to take extra measures to make them feel more comfortable in these lawsuit-happy times. One way is to offer an LLC indemnity agreement, guaranteeing direct payment by the LLC for any legal expenses or judgments arising out of a manager's work for the LLC. Another personal safeguard is to cover managers personally with an errors and omissions insurance policy for their managerial duties. The two can be combined for complete legal coverage:

Indemnification can kick in for all amounts not covered by insurance.

One final point about managers: State law typically invests each manager of a manager-managed LLC with “agency” authority. That is, each manager has legal authority to bind the LLC to contracts and business deals made with outsiders. You will want to make sure to select managers you can trust.

Exception: State law normally says a manager's acts will not bind the LLC if (1) the acts were not the type of business the LLC normally would transact or, (2) even if the acts were the type of business the LLC would normally transact, the manager did not have the actual authority to enter into the deal and the outsider knew the manager didn't. These exceptions are rare—don't expect to be able to rely on either them if a manager commits your LLC to a bad business deal.

How to Prepare an LLC Management Operating Agreement

Now let's look at the LLC management operating agreement. Note that this is the second operating agreement in Appendix B, titled Limited Liability Company Management Operating Agreement. You can tear the agreement out now to follow along with the instructions if you wish. Make sure you pick the right agreement and don't miss any pages.



FORMS

Where to find forms in this book. If you're reading a print copy of this book, you'll find copies of the Limited Liability Company Management Operating Agreement form on the CD-ROM that comes with the book. If you're using an eBook

version, you can download this form on the Nolo website; the link is included in Appendix C. Both the print copy and eBook versions include tear-out versions of the forms (found in Appendix B) and filled-in samples in the text.

Read Chapter 5 Material on Basic Operating Agreement Issues

The management operating agreement is similar to the operating agreement provided in Chapter 5, but it is customized to include LLC manager provisions. Before you begin filling in your LLC management operating agreement, read these two sections of Chapter 5, which apply to both member-managed and manager-managed LLCs:

- **“See an Expert for Adding Special Capital Account Provisions or Buy-Sell Provisions to Your Operating Agreement.”** There, you’ll find information about capital account provisions and buy-sell and right-of-first-refusal provisions.
- **“Customizing Your LLC Operating Agreement.”** This covers general rules on when and how to make changes to your agreement.

How to Use Instructions for LLC Management Operating Agreement

Below, we provide instructions in the sample agreement to help you fill in the blanks. In addition, we use two different kinds of references to alert you to special instructions:

- **Lettered references** accompany provisions that are unique to this management operating agreement. Special Instructions **A** through **N** accompany the management operating agreement in this chapter.
- **Numbered references** apply to provisions that are the same as (or almost identical to) those found in the Chapter 5 agreement (Operating Agreement for Member-

Managed Limited Liability Company). Special instructions **1** through **49** are in Chapter 5. Because certain provisions in Chapter 5 apply only to member-managed LLCs, they are not carried over to this management operating agreement, and the numbers are not consecutive.

Line-by-Line Instructions for Management Operating Agreement

We’ll start at the top of the Limited Liability Company Management Operating Agreement and work our way through it.

Special Instructions for Limited Liability Company Management Operating Agreement

A Fill in the name(s) and address(es) of the manager(s) of the LLC—you only need one manager, but many LLCs have more than one person on their management teams. Check the appropriate box to show whether each manager is a member or nonmember.

B This paragraph reiterates the basic legal rule that managers (like members) are not personally liable for LLC debts and claims.

C In the blank, specify how many management votes are necessary to pass or approve decisions submitted to the managers. You may select “all” or “a majority,” or specify a particular number or percentage of votes needed to make a management decision, such as “two-thirds,” “51%,” or “three.” We recommend specifying percentages or fractions, rather than numbers, because a specified number may turn out to be too small if you increase the size of your management team later. For example, if you require three management votes for a management team currently consisting of five persons, and you later add one more manager to your LLC, this number will represent less than a majority.

Sample Operating Agreement for Manager-Managed LLC

Limited Liability Company Management Operating Agreement

I. Preliminary Provisions

[Here we address preliminary matters, such as the effective date of the agreement, the name of the LLC, and other basic information. These provisions are almost identical to those provided in the basic LLC operating agreement in Chapter 5.]

(1) Effective Date: This operating agreement of [name of LLC] ❶ ,
effective [date] ❷ , is adopted
by the members whose signatures appear at the end of this agreement. ❸

(2) Formation: This limited liability company (LLC) was formed by filing articles of organization, certificate of formation, or a similar organizational document with the LLC filing office of the state of [state of formation] on [date of filing articles of organization, certificate of formation, or similar organizational document] . ❹
A copy of this organizational document has been placed in the LLC's records book.

(3) Name: The formal name of this LLC is as stated above. However, this LLC may do business under a different name by complying with the state's fictitious or assumed business name statutes and procedures. ❺

(4) Registered Office and Agent: The registered office of this LLC and the registered agent at this address are as follows: [name and address of registered agent and office] .

The registered office and agent may be changed from time to time as the members or managers may see fit, by filing a change of registered agent or office form with the state LLC filing office. It will not be necessary to amend this provision of the operating agreement if and when such a change is made. ❻

(5) Business Purposes: The specific business purposes and activities contemplated by the founders of this LLC at the time of initial signing of this agreement consist of the following:

 [state the specific business purposes and activities you foresee for your LLC] ❷

_____.

It is understood that the foregoing statement of purposes shall not serve as a limitation on the powers or abilities of this LLC, which shall be permitted to engage in any and all lawful business activities. If this LLC intends to engage in business activities outside the state of its formation that require the qualification of the LLC in other states, it shall obtain such qualification before engaging in such out-of-state activities.

Sample Operating Agreement for Manager-Managed LLC (cont'd)

(6) Duration of LLC: The duration of this LLC shall be ["perpetual" or any specific termination date or term of years for the LLC, as specified in the articles of organization]. Further, this LLC shall terminate when a proposal to dissolve the LLC is adopted by the membership of this LLC or when this LLC is otherwise terminated in accordance with law. **8**

II. Management Provisions

[These provisions address the unique management structure of a manager-managed LLC. The lettered special instructions for these provisions accompany the agreement in this chapter.]

(1) Management by Managers: This LLC will be managed by the managers listed below. All managers who are also members of this LLC are designated as "members"; nonmember managers are designated as "nonmembers." **A**

Name: _____ ☐ Member ☐ Nonmember

Address: _____

Name: _____ ☐ Member ☐ Nonmember

Address: _____

Name: _____ ☐ Member ☐ Nonmember

Address: _____

Name: _____ ☐ Member ☐ Nonmember

Address: _____

Name: _____ ☐ Member ☐ Nonmember

Address: _____

Name: _____ ☐ Member ☐ Nonmember

Address: _____

Sample Operating Agreement for Manager-Managed LLC (cont'd)

(2) Nonliability of Managers: No manager of this LLC shall be personally liable for the expenses, debts, obligations, or liabilities of the LLC, or for claims made against it. **B**

(3) Authority and Votes of Managers: Except as otherwise set forth in this agreement, the Articles of Organization, Certificate of Organization, or similar organizational document, or as may be provided under state law, all management decisions relating to this LLC's business shall be made by its managers. Management decisions shall be approved by _____ ["all" or "a majority"] _____ of the current managers of the LLC, with each manager entitled to cast one vote for or against any matter submitted to the managers for a decision. **C**

(4) Term of Managers: Each manager shall serve until the earlier of the following events:

- (a) the manager becomes disabled, dies, retires, or otherwise withdraws from management
- (b) the manager is removed from office, or **D**
- (c) the manager's term expires, if a term has been designated in other provisions of this agreement.

Upon the happening of any of these events, a new manager may be appointed to replace the departing manager by _____ ["a majority of the members of the LLC" or "a majority of the remaining managers"] _____. **E**

(5) Management Meetings: Managers shall be able to discuss and approve LLC business informally, and may, at their discretion, call and hold formal management meetings according to the rules set forth in the following provisions of this operating agreement.

Regularly scheduled formal management meetings need not be held, but any manager may call such a meeting by communicating his or her request for a formal meeting to the other managers, noting the purpose or purposes for which the meeting is called. Only the business stated or summarized in the notice for the meeting shall be discussed and voted upon at the meeting.

The meeting shall be held within a reasonable time after a manager has made the request for a meeting and in no event later than _____ [period] _____ days after the request for the meeting. A quorum for such a formal managers' meeting shall consist of _____ ["all" or "a majority of"] _____ managers, and if a quorum is not present, the meeting shall be adjourned to a new place and time with notice of the adjourned meeting given to all managers. An adjournment shall not be necessary, however, and a managers' meeting with less than a quorum may be held if all nonattending managers agreed in writing prior to the meeting to the holding of the meeting. All such written consents to the holding of a formal management meeting shall be kept and filed with the records of the meeting. **F**

The proceedings of all formal managers' meetings shall be noted or summarized with written minutes of the meeting and a copy of the minutes shall be placed and kept in the records book of this LLC.

Note that this provision states the standard rule that each manager gets one vote, regardless of any percentage interest he or she may hold in the LLC as a member.

D You may wish to use your operating agreement to state procedures for the removal of LLC managers. You may want to specify the membership votes needed for removal of a manager, or the automatic grounds for such removal. You can even specify a procedure whereby the managers themselves vote to remove another manager.

Sample Language: Removal of Managers:

Managers may be removed by the vote of ["a majority of the members" or "all of the members"], not counting the vote of any manager to be removed. [You may also specify one or more automatic reasons for removal of a manager; for example: "A member-manager shall be removed automatically from office upon missing two or more consecutive meetings of the managers without giving reasonable written notice of such expected absence to the other managers of the LLC prior to the meeting."]

E Our provision gives an unspecified term for managers—that is, it doesn't contain a periodic election procedure for managers. This provision does specify a procedure to fill a vacancy on the management team. In the blank, indicate the vote requirement necessary for the remaining managers or members to accomplish this. If you require a majority vote of members, keep in mind that a majority vote will be defined in "III. Membership Provisions: (4) Membership Voting" as the vote of a majority of the percentage interests of the members—unless you provide a special formula to use for filling a vacancy by members. Conversely, a majority of managers under paragraph (3) of this section of the agreement means the per capita (one person, one vote)

majority vote of the remaining LLC managers.

You may wish to limit the terms of managers by providing for their periodic election. Here is an optional management election provision you can add to this provision to require the annual election of managers by the members.

Sample Language: Election of Managers:

The membership of this LLC shall meet every year on [date] to nominate and elect [number] member-managers and [number] nonmember-managers of the LLC. [You may specify a procedure for voting and how the number of votes to be cast are to be calculated; for example: "Voting by the membership at this election shall be as follows: according to "capital interests" or "per capita voting." You may want to exclude member-managers from voting in this election or add other provisions to suit your needs.]

Written or electronic notice of this annual membership meeting, its purpose, and the name of anyone nominated as of the date of the notice, shall be mailed, delivered, or personally given to each member of this LLC no later than [period, typically "30 days"] prior to the date of the annual meeting.

The term of office for each manager so elected shall be for one year, and until his or her successor is elected by the membership at the next annual membership meeting and such successor accepts his or her office.

F This provision explains that management decisions may be made either informally or at a formal meeting of managers. This is a flexible provision with the following key points:

- **Managers don't have to call formal meetings to make ordinary business decisions.** A formal meeting is only necessary if you want the managers to meet in person at a prearranged time or if you want to make a written record of a decision.

- **Only the business communicated in the call for the formal meeting by the manager may be taken up at the meeting.** We think this makes sense for formally called and held management meetings, to give all managers fair opportunity to prepare for the discussion. But you can change our language to allow any business to be discussed and voted upon at a formal meeting. For example, you can change the language to read “Any business may be discussed and voted upon at a formal managers’ meeting, whether or not stated or summarized in the notice for the meeting or written consent signed by a nonattending member.”
- **Formal management decisions—those you wish to record in your LLC records book—should be approved by the vote requirement specified in the manager voting provision of your agreement.** The vote requirement is covered in “II. Management Provisions: (3) Authority and Votes of Managers.”
- **Formal management meetings may be called by any manager.** Formal meetings must be held “within a reasonable time” of the call (request) for the meeting, subject to a final date (no later than a specified number of days after the request for the meeting—for example, 30 or 60 days). You may change these provisions to specify minimum and maximum timelines—for example, requiring the holding of a meeting no less than 10 or more than 60 days after a request for a meeting.
- **You can set the quorum requirement—the number or percentage of managers who must be present to hold a formal management meeting.** You may specify “all,” “a majority,” or some other portion of the managers as a quorum. If you specify a quorum requirement and a quorum is not in

attendance, the meeting must be adjourned unless all nonattending managers give written consent ahead of time, agreeing to the holding of the meeting for one or more specified purposes even though they can’t attend. A simple signed note to this effect is enough.



RESOURCE

Learn more about manager meetings. See Chapter 7 for details on when and how to conduct and document formal LLC meetings.

Our provisions are adequate for most smaller LLCs. If the formal management meeting provisions don’t suit your needs, you are free to change them. For example, even though the managers of most smaller LLCs should normally meet and make decisions face-to-face at a formal managers’ meeting, you can add language allowing technologically assisted participation—such as through a networked meeting via online interactive chats, video, or telephone conferences. You also can allow your managers to make decisions by unanimous written consent (unanimity is typically required for written management decisions under state law, so check your state LLC act if this interests you).

Again, bear in mind that if an issue is important enough to require the time and consideration of your managers to make and record a formal decision, it’s probably best for the managers to talk with one another in person, not just to mail, fax, or email in their votes.

⑥ This provision expresses the desire of the LLC to obtain maximum energy and effort from each LLC manager, and prohibits managers from working in or for outside businesses that compete with the LLC’s business or in any business if doing so detracts from

Sample Operating Agreement for Manager-Managed LLC (cont'd)

(6) Managers' Commitment to the LLC: Managers shall devote their best efforts and energy working to achieve the business objectives and financial goals of this LLC. By agreeing to serve as a manager for the LLC, each manager shall agree not to work for another business, enterprise, or endeavor, owned or operated by himself or herself or others, if such outside work or efforts would compete with the LLC's business goals, mission, products, or services, or would diminish or impair the manager's ability to provide maximum effort and performance to managing the business of this LLC. ⑥

(7) Compensation of Managers: Managers of this LLC may be paid per-meeting or per diem amounts for attending management meetings, may be reimbursed actual expenses advanced by them to attend management meetings or attend to management business for the LLC, and may be compensated in other ways for performing their duties as managers. Managers may work in other capacities for this LLC and may be compensated separately for performing these additional services, whether as officers, staff, consultants, independent contractors, or in other capacities. ⑦

III. Membership Provisions

[The membership provisions are nearly identical to those provided in Section II of the member-managed LLC operating agreement; where indicated, see the corresponding numbered instructions in Chapter 5.]

(1) Nonliability of Members: No member of this LLC shall be personally liable for the expenses, debts, obligations, or liabilities of the LLC, or for claims made against it. ⑨

(2) Reimbursement for Organizational Costs: Members shall be reimbursed by the LLC for organizational expenses paid by the members. The LLC shall be authorized to elect to deduct and amortize organizational expenses and start-up expenditures as permitted by the Internal Revenue Code and as may be advised by the LLC's tax adviser. ⑩

(3) Members' Percentage Interests: A member's percentage interest in this LLC shall be computed as a fraction, the numerator of which is the total of a member's capital account and the denominator of which is the total of all capital accounts of all members. This fraction shall be expressed in this agreement as a percentage, which shall be called each member's "percentage interest" in this LLC. ⑫

(4) Membership Voting: Except as otherwise may be required by the articles of organization, certificate of formation, or a similar organizational document, by other provisions of this operating agreement, or under the laws of this state, each member shall vote on any matter submitted to the membership for approval in proportion to the member's percentage interest in this LLC. Further, unless defined otherwise for a particular provision of this operating agreement, the phrase "majority of members" means the vote of members whose combined votes equal more than 50% of the votes of all members in this LLC, and a majority of members, so defined, may approve any item of business brought before the membership for a vote unless a different vote is required under this operating agreement or state law. ⑬

Sample Operating Agreement for Manager-Managed LLC (cont'd)

(5) Compensation: Members shall not be paid as members of the LLC for performing any duties associated with such membership. Members may be paid, however, for any services rendered in any other capacity for the LLC, whether as officers, employees, independent contractors, or otherwise. **14**

(6) Members' Meetings: The LLC shall not provide for regular members' meetings. However, any member may call a meeting by communicating his or her wish to schedule a meeting to all other members. Such notification may be in person or in writing, or by telephone, facsimile machine, or other form of electronic communication reasonably expected to be received by a member, and the other members shall then agree, either personally, in writing, or by telephone, facsimile machine, or other form of electronic communication to the member calling the meeting, to meet at a mutually acceptable time and place. Notice of the business to be transacted at the meeting need not be given to members by the member calling the meeting, and any business may be discussed and conducted at the meeting.

If all members cannot attend a meeting, it shall be postponed to a date and time when all members can attend, unless all members who do not attend have agreed in writing to the holding of the meeting without them. If a meeting is postponed, and the postponed meeting cannot be held either because all members do not attend the postponed meeting or the nonattending members have not signed a written consent to allow the postponed meeting to be held without them, a second postponed meeting may be held at a date and time announced at the first postponed meeting. The date and time of the second postponed meeting shall also be communicated to any members not attending the first postponed meeting. The second postponed meeting may be held without the attendance of all members as long as a majority of the percentage interests of the membership of this LLC is in attendance at the second postponed meeting. Written notice of the decisions or approvals made at this second postponed meeting shall be mailed or delivered to each nonattending member promptly after the holding of the second postponed meeting. **15**

Written minutes of the discussions and proposals presented at a members' meeting, and the votes taken and matters approved at such meeting, shall be taken by one of the members or a person designated at the meeting. A copy of the minutes of the meeting shall be placed in the LLC's records book after the meeting. **16**

(7) Membership Certificates: This LLC shall be authorized to obtain and issue certificates representing or certifying membership interests in this LLC. Each certificate shall show the name of the LLC and the name of the member, and state that the person named is a member of the LLC and is entitled to all the rights granted members of the LLC under the articles of organization, certificate of formation, or a similar organizational document, this operating agreement, and provisions of law. Each membership certificate shall be consecutively numbered and signed by one or more officers of this LLC. The certificates shall include any additional information considered appropriate for inclusion by the members on membership certificates.

Sample Operating Agreement for Manager-Managed LLC (cont'd)

In addition to the above information, all membership certificates shall bear a prominent legend on their face or reverse side stating, summarizing, or referring to any transfer restrictions that apply to memberships in this LLC under the articles of organization, certificate of formation, or a similar organizational document, and/or this operating agreement; as well as the address where a member may obtain a copy of these restrictions upon request from this LLC.

The records book of this LLC shall contain a list of the names and addresses of all persons to whom certificates have been issued, show the date of issuance of each certificate, and record the date of all cancellations or transfers of membership certificates. 17

IV. Tax and Financial Provisions

[The tax and financial provisions below are very similar to those provided in Section III of the member-managed LLC operating agreement, but they are extended to apply to LLC managers. Where indicated, see the corresponding numbered instructions in Chapter 5.]

(1) Tax Classification of LLC: The members of this LLC intend that this LLC be initially classified as a ["partnership" or "sole proprietorship of the sole member" or "corporation"] for federal and, if applicable, state income tax purposes. It is understood that, subject to federal and state law requirements, all members may agree to change the tax treatment of this LLC by signing, or authorizing the signature of, IRS Form 8832, Entity Classification Election, and filing it with the IRS and, if applicable, the state tax department within the prescribed time limits. 19

(2) Tax Year and Accounting Method: The tax year of this LLC shall be ["the calendar year" or specify a noncalendar year period, such as "July 1 to June 30"]. The LLC shall use the ["cash" or "accrual"] method of accounting. Both the tax year and the accounting period of the LLC may be changed with the consent of all members or all managers if the LLC qualifies for such change, and may be effected by the filing of appropriate forms with the IRS and state tax authorities. 20

(3) Tax Matters Partner: If this LLC is required under Internal Revenue Code provisions or regulations, it shall designate from among its members or member-managers a "tax matters partner" in accordance with Internal Revenue Code Section 6231(a)(7) and corresponding regulations, who will fulfill this role by being the spokesperson for the LLC in dealings with the IRS as required under the Internal Revenue Code and Regulations, and who will report to the members and managers on the progress and outcome of these dealings. 21

the manager's ability to perform properly for the LLC.

This is a general noncompetition provision, and you may wish to tighten it up a little. For example, we've carefully avoided saying that managers must work full-time for the LLC (as managers or in other capacities), because this is not always the case. You can add language that requires such full-time effort, or go the other way and permit involvement with outside businesses or personal projects by your managers as long as they don't compete with the LLC's business.

EXAMPLE:

Ted and Jill found Bird Nest Bed & Breakfast, LLC. They have the money and energy to buy, set up, and maintain a few scenically situated bed and breakfast cottages in their home town—a suburban location outside a major metropolitan area. The two members are new to the B&B business and decide to bring in Elaine, an experienced B&B consultant, to help organize and operate the LLC. Elaine will work part-time on a consulting basis, plus be given a small stake in LLC profits for joining Ted and Jill as a formal manager of the LLC. Their operating agreement allows Elaine to do consulting work for other businesses, whether in the B&B or unrelated areas of operation, as long as this outside work does not interfere with her ability to provide best management efforts for the LLC.

Don't make changes to this provision that further restrict the activities of managers. Courts are often reluctant to enforce restrictions on how hard individuals work, and for whom. You may be able to sue a manager who strays from the fold in contravention of your noncompetition provision or for

nonperformance of his or her duties under an employment agreement, but don't expect a court to order a person to return to work for you, or work harder for your LLC—this just won't happen.

Also realize that provisions of this sort are really best viewed as an expression of the parties' expectations, rather than ironclad legal language. If a manager wishes to stray or stay away from your LLC, your best solution is to acquiesce—and find a more suitable replacement on your management team.

Ⓜ This broad provision says managers may receive per-meeting, per-diem, or other payment or compensation for serving as managers. It allows managers to serve and be paid for performing work for the LLC in other capacities as officers, employees, and independent contractors.

Even though this provision allows for a multitude of arrangements, typically managers also work for the LLC on a day-to-day basis in officer or employee positions (for example, as president, sales manager, or chief financial officer) and do not receive payment for also serving as managers. But you may wish to make other arrangements if you bring in nonmember managers who only work part-time as managers. That is, if they do not work in other capacities for your LLC, you may want to pay your managers as managers. The details of these arrangements are up to you; this provision allows you to pay managers in any capacity you wish.

Note that managers may not wish to receive direct payment for managing an LLC. If the manager is an investor in the LLC, that person's capital and/or profits interest in the LLC would likely be the expected payment, rather than direct payment for intermittent or part-time management services.

EXAMPLE:

Sals' Berry Farms, a two-person LLC owned and operated by a married couple, Salvatore and Sally, owns and operates a California berry-growing business. The spouses bought the business from the prior owners, who have been kept on as managers of the LLC. Sally and Sal are on the management team too, but they receive compensation as vice presidents of operations, not as managers. The prior owners sold the business for a lump-sum buyout payment plus a 20% share in future profits for the next five years. These nonmember managers of the LLC are not paid in their capacities as managers—they are content to let their management efforts pay off in a more important and lucrative fashion—namely, by boosting the value of their 20% profits interest in the business.

Finally, note that managers of smaller management-run LLCs normally approve the amount of payment, if any, each person gets for performing management duties. You may, however, let LLC members decide the compensation issue. By adding the following sample language to the end of this provision, you allow members who are not managers to approve payments to managers. The managers are still allowed to approve smaller amounts, such as reimbursements or per-meeting or per diem payments.

Sample Language: Except for per-meeting or per diem amounts, or reimbursement of actual expenses paid to managers, the nonmanaging members of this LLC shall approve compensation and other payments to managers for performing management duties for this LLC.

❶ This is a general authorization paragraph that allows the LLC to establish accounts with banks and other institutions. It allows

the managers to unanimously designate one or more LLC employees to deposit into and withdraw funds from these accounts, and to direct the investment of funds held in these accounts.

Note that unanimous consent is required to designate a person or persons to have this depositing/check-writing authority, but you can lessen this requirement if you wish by simply deleting the words “with the consent of all managers” from the second sentence of this paragraph. You may also alter, rather than delete, the language, for example, “with the consent of the majority of members.”

In many businesses, multiple signatures may be required for withdrawals that exceed a specified amount. You don't need to specify these arrangements in your operating agreement. The details of these check-writing and investment-directing arrangements will be spelled out on the bank's signature cards and paperwork you must fill in when opening bank accounts on behalf of your LLC.

The final sentence in this paragraph is a reminder that personal funds of the LLC members and managers may not be commingled (mixed) with the funds of the LLC. If you commingle funds, a state court may decide that you and the other members and/or managers are not entitled to limited liability protection normally afforded an LLC, and may hold members and managers personally liable for LLC debts and claims.

❶ This provision gives members or managers leeway to distribute cash profits or proceeds of the LLC to members if they vote to do so. Many smaller LLCs will trust their managers to make these allocations and distributions, but some may wish to leave important financial decisions of this sort strictly to the members themselves, or require the approval of both managers and members.

Sample Operating Agreement for Manager-Managed LLC (cont'd)

(2) Additional Contributions by Members: The members may agree, from time to time by unanimous vote, to require the payment of additional capital contributions by the members, on or by a mutually agreeable date. 26

(3) Failure to Make Contributions: If a member fails to make a required capital contribution within the time agreed for a member's contribution, the remaining members may, by unanimous vote, agree to reschedule the time for payment of the capital contribution by the late-paying member, setting any additional repayment terms, such as a late payment penalty, rate of interest to be applied to the unpaid balance, or other monetary amount to be paid by the delinquent member, as the remaining members decide. Alternatively, the remaining members may, by unanimous vote, agree to cancel the membership of the delinquent member, provided any prior partial payments of capital made by the delinquent member are refunded by the LLC to the member promptly after the decision is made to terminate the membership of the delinquent member. 27

(4) No Interest on Capital Contributions: No interest shall be paid on funds or property contributed as capital to this LLC, or on funds reflected in the capital accounts of the members. 28

(5) Capital Account Bookkeeping: A capital account shall be set up and maintained on the books of the LLC for each member. It shall reflect each member's capital contribution to the LLC, increased by each member's share of profits in the LLC, decreased by each member's share of losses and expenses of the LLC, and adjusted as required in accordance with applicable provisions of the Internal Revenue Code and corresponding income tax regulations. 29

(6) Consent to Capital Contribution Withdrawals and Distributions: Members shall not be allowed to withdraw any part of their capital contributions or to receive distributions, whether in property or cash, except as otherwise allowed by this agreement and, in any case, only if such withdrawal is made with the written consent of all members. 30

(7) Allocations of Profits and Losses: No member shall be given priority or preference with respect to other members in obtaining a return of capital contributions, distributions or allocations of the income, gains, losses, deductions, credits, or other items of the LLC. The profits and losses of the LLC, and all items of its income, gain, loss, deduction, and credit shall be allocated to members according to each member's percentage interest in this LLC. 31

(8) Allocation and Distribution of Cash to Members: Cash from LLC business operations, as well as cash from a sale or other disposition of LLC capital assets, may be distributed from time to time to members in accordance with each member's percentage interest in the LLC, as may be decided by _____ ["all" or "a majority"] of the _____ ["members," "managers," "members and managers," or "members or managers"] . 32

Sample Operating Agreement for Manager-Managed LLC (cont'd)

(9) Allocation of Noncash Distributions: If proceeds consist of property other than cash, the ["members," "managers," "members and managers," or "members or managers"] shall decide the value of the property and allocate such value among the members in accordance with each member's percentage interest in the LLC. If such noncash proceeds are later reduced to cash, such cash may be distributed among the members as otherwise provided in this agreement. **K**

(10) Allocation and Distribution of Liquidation Proceeds: Regardless of any other provision in this agreement, if there is a distribution in liquidation of this LLC, or when any member's interest is liquidated, all items of income and loss shall be allocated to the members' capital accounts, and all appropriate credits and deductions shall then be made to these capital accounts before any final distribution is made. A final distribution shall be made to members only to the extent of, and in proportion to, any positive balance in each member's capital account. **34**

VI. Membership Withdrawal and Transfer Provisions

[These provisions, which are the same as those provided in Section V of the member-managed LLC operating agreement in Chapter 5, deal with members deciding to leave the LLC. We specifically require a unanimous vote to admit a transferee (someone who buys or is otherwise transferred an LLC interest from a member) as a new member of the LLC.]

(1) Withdrawal of Members: A member may withdraw from this LLC by giving written notice to all other members at least [number of days] days before the date the withdrawal is to be effective. **35**

(2) Restrictions on the Transfer of Membership: A member shall not transfer his or her membership in the LLC unless all nontransferring members in the LLC first agree to approve the admission of the transferee into this LLC. Further, no member may encumber a part or all of his or her membership in the LLC by mortgage, pledge, granting of a security interest, lien, or otherwise, unless the encumbrance has first been approved in writing by all other members of the LLC. **36**

Notwithstanding the above provision, any member shall be allowed to assign an economic interest in his or her membership to another person without the approval of the other members. Such an assignment shall not include a transfer of the member's voting or management rights in this LLC, and the assignee shall not become a member of the LLC. **37**

Most smaller LLCs will specify a unanimous vote, but some may prefer to allow just a majority of the members and/or managers to decide this issue. Remember, a majority of members is defined in “III. Membership Provisions: (4) Membership Voting” as a majority of the percentage interests in the LLC, whereas a majority of managers is determined on a per capita basis (according to “II. Management Provisions: (3) Authority and Votes of Managers”).

Again, we assume that allocations of profits and proceeds will follow each member’s percentage interest in the LLC, but you can vary who gets how much if you (with help from your tax adviser) decide to implement disproportionate (special) allocations of LLC profits.

K This paragraph addresses how any non-cash LLC property will be allocated among members. As with the previous provision, you may want to leave these decisions to just members or managers, or have either or both approve them.

Whoever decides, this provision says that property gets allocated among members in proportion to each member’s percentage interest in the LLC. If reduced to cash later, it will be distributed to members according to the previous provision in this operating agreement.

EXAMPLE:

Second-Hand Freight and Salvage, Ltd. Liability Co., a five-member company with three member-managers, decides (by a unanimous manager vote as provided in its operating agreement) to sell a truck and allocate the current value of this asset to all five members, who own the LLC in equal percentages. The truck is worth \$30,000, so the capital account of each member is increased by \$6,000. The members and/or

managers can vote to distribute this cash according to the cash distribution provision in their agreement.

L Your state LLC statute may allow you to restrict when or why members or managers are allowed to look at LLC records, or restrict access to particular types of LLC legal or financial records. We don’t nitpick here, and simply give all members and managers an unrestricted right to view all records at any time.

If you want to restrict inspection rights, take a look at your state LLC statute to see how restrictive you are allowed to be under state law, then insert your own provisions. Normally, you will not wish to limit manager’s rights—managers may need to look at LLC legal or financial records on a moment’s notice to make a management decision—but you may wish to restrict members’ inspection rights. Here’s some sample language to accomplish this:

Sample Language: Any member may inspect the financial or other records of this LLC for a purpose reasonably related to the member’s interest in this LLC. The Treasurer of this LLC shall make the determination within one week of the member’s request and, if the Treasurer finds that the member’s request is related to his or her interest in the LLC, the requesting member shall be allowed to inspect the records during regular business hours of the LLC at its principal place of business.

M Have each of your managers (one or more) sign and date at the bottom of the form. A manager who is also a member should sign and date the operating agreement in two places: once as member on the members’ lines (Section 1), and a second time as a manager here, on the manager lines (Section 3).

Sample Operating Agreement for Manager-Managed LLC (cont'd)

VII. Dissolution Provisions

[This section addresses the dissolution of the LLC, or events that may trigger a dissolution. It is identical to Section VI of the member-managed operating agreement in Chapter 5. In Section 1(a), we specifically require the vote of all remaining members to continue the business of the LLC after a member is dissociated (loses his or her membership interest).]

(1) Events That Trigger Dissolution of the LLC: The following events shall trigger a dissolution of the LLC, except as provided:

- (a) the death, permanent incapacity, bankruptcy, retirement, resignation, or expulsion of a member, except that within [number of days (typically a maximum of 90 under remaining state LLC default rules)] of the happening of any of these events, all remaining members of the LLC may vote to continue the legal existence of the LLC, in which case the LLC shall not dissolve ³⁸
- (b) the expiration of the term of existence of the LLC if such term is specified in the articles of organization, certificate of formation, or a similar organizational document, or this operating agreement ³⁹
- (c) the written agreement of all members to dissolve the LLC, or ⁴⁰
- (d) entry of a decree of dissolution of the LLC under state law. ⁴¹

VIII. General Provisions

[The housekeeping and miscellaneous provisions here are almost identical to those provided in Section VII of the member-managed LLC operating agreement; see the corresponding instructions in Chapter 5.]

(1) Officers: The managers of this LLC may designate one or more officers, such as a president, vice president, secretary, and treasurer. Persons who fill these positions need not be members or managers of the LLC. Such positions may be compensated or noncompensated according to the nature and extent of the services rendered for the LLC as a part of the duties of each office. Ministerial services only as a part of any officer position will normally not be compensated, such as the performance of officer duties specified in this agreement, but any officer may be reimbursed by the LLC for out-of-pocket expenses paid by the officer in carrying out the duties of his or her office. ⁴²

(2) Records: The LLC shall keep at its principal business address a copy of all proceedings of membership meetings, as well as books of account of the LLC's financial transactions. A list of the names and addresses of the current membership of the LLC also shall be maintained at this address, with notations on any transfers of members' interests to nonmembers or persons being admitted into membership in the LLC. A list of the current managers' names and addresses shall also be kept at this address.

Sample Operating Agreement for Manager-Managed LLC (cont'd)

Copies of the LLC's articles of organization, certificate of formation, or a similar organizational document, a signed copy of this operating agreement, and the LLC's tax returns for the preceding three tax years shall be kept at the principal business address of the LLC. A statement also shall be kept at this address containing any of the following information that is applicable to this LLC:

- the amount of cash or a description and value of property contributed or agreed to be contributed as capital to the LLC by each member
- a schedule showing when any additional capital contributions are to be made by members to this LLC
- a statement or schedule, if appropriate, showing the rights of members to receive distributions representing a return of part or all of members' capital contributions, and
- a description of, or date when, the legal existence of the LLC will terminate under provisions in the LLC's articles of organization, certificate of formation, or a similar organizational document, or this operating agreement.

If one or more of the above items is included or listed in this operating agreement, it will be sufficient to keep a copy of this agreement at the principal business address of the LLC without having to prepare and keep a separate record of such item or items at this address.

Any member or manager may inspect any and all records maintained by the LLC upon reasonable notice to the LLC. Copying of the LLC's records by members and managers is allowed, but copying costs shall be paid for by the requesting member or manager. **L**

(3) All Necessary Acts: The members, managers, and officers of this LLC are authorized to perform all acts necessary to perfect the organization of this LLC and to carry out its business operations expeditiously and efficiently. The Secretary of the LLC, or other officers, or one or more managers, or all members of the LLC, may certify to other businesses, financial institutions, and individuals as to the authority of one or more members, managers, or officers of this LLC to transact specific items of business on behalf of the LLC. **44**

(4) Mediation and Arbitration of Disputes Among Members: In any dispute over the provisions of this operating agreement and in other disputes among the members, if the members cannot resolve the dispute to their mutual satisfaction, the matter shall be submitted to mediation. The terms and procedure for mediation shall be arranged by the parties to the dispute.

If good-faith mediation of a dispute proves impossible or if an agreed-upon mediation outcome cannot be obtained by the members who are parties to the dispute, the dispute may be submitted to arbitration in accordance with the rules of the American Arbitration Association. Any party may commence arbitration of the dispute by sending a written request for arbitration to all other parties to the dispute. The request shall state the nature of the dispute to be resolved by arbitration, and, if all parties to the dispute agree to arbitration, arbitration shall be commenced as soon as practical after such parties receive a copy of the written request.

Sample Operating Agreement for Manager-Managed LLC (cont'd)

All parties shall initially share the cost of arbitration, but the prevailing party or parties may be awarded attorney fees, costs, and other expenses of arbitration. All arbitration decisions shall be final, binding, and conclusive on all the parties to arbitration, and legal judgment may be entered based upon such decision in accordance with applicable law in any court having jurisdiction to do so. ⁴⁵

(5) Entire Agreement: This operating agreement represents the entire agreement among the members of this LLC, and it shall not be amended, modified, or replaced except by a written instrument executed by all the parties to this agreement who are current members of this LLC as well as any and all additional parties who became members of this LLC after the adoption of this agreement. This agreement replaces and supersedes all prior written and oral agreements among any and all members of this LLC. ⁴⁶

(6) Severability: If any provision of this agreement is determined by a court or arbitrator to be invalid, unenforceable, or otherwise ineffective, that provision shall be severed from the rest of this agreement, and the remaining provisions shall remain in effect and enforceable. ⁴⁷

IX. Signatures of Members, Members' Spouses, and Managers

[The signature lines for members and their spouses are the same as those provided in Section VIII of the LLC member-managed operating agreement in Chapter 5 (see the corresponding instructions), but we also include date and signature lines for your manager(s).]

(1) Execution of Agreement: In witness whereof, the members of this LLC sign and adopt this agreement as the operating agreement of this LLC.

Date: _____ ⁴⁸

Signature: _____

Printed Name: _____, Member

Date: _____

Signature: _____

Printed Name: _____, Member

Date: _____

Signature: _____

Printed Name: _____, Member

Date: _____

Signature: _____

Printed Name: _____, Member

Sample Operating Agreement for Manager-Managed LLC (cont'd)

(2) Consent of Spouses: The undersigned are spouses of the members of this LLC who have signed this operating agreement in the preceding provision. These spouses have read this agreement and agree to be bound by its terms in any matter in which they have a financial interest, including restrictions on the transfer of memberships and the terms under which memberships in this LLC may be sold or otherwise transferred. 49

Date: _____

Signature: _____

Printed Name: _____

Spouse of: _____

Date: _____

Signature: _____

Printed Name: _____

Spouse of: _____

Date: _____

Signature: _____

Printed Name: _____

Spouse of: _____

Date: _____

Signature: _____

Printed Name: _____

Spouse of: _____

Sample Operating Agreement for Manager-Managed LLC (cont'd)

(3) Signatures of Managers: The undersigned managers of this limited liability company have read this agreement and agree to be bound by its terms in discharging their duties as managers. **M**

Date: _____

Signature: _____

Printed Name: _____, Manager

Date: _____

Signature: _____

Printed Name: _____, Manager

Date: _____

Signature: _____

Printed Name: _____, Manager

Date: _____

Signature: _____

Printed Name: _____, Manager

Distribute Copies of Your Operating Agreement

Congratulations! You are done with another important organizational task, and your LLC is well on its legal way. Make photocopies of

the completed, signed management operating agreement and give each member and manager a copy. Finally, place the original, signed agreement in your LLC records book. ●

After Forming Your LLC

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In this chapter, we discuss legal and procedural formalities that you may need to tend to after setting up your limited liability company, such as preparing meeting minutes and other LLC legal paperwork. We suggest you skim through the chapter and get a general sense of the work you may need to do. If any topic seems pertinent, carefully read the discussion.

It's important to keep in mind that LLCs are relatively new, so trying to anticipate the ongoing issues and concerns particular to LLCs is a bit of a guessing game. For now, we cover operational tasks and issues we believe are most likely to apply. We're sure you'll be on the lookout for other LLC matters, and should be able to handle them successfully using common sense and good business judgment (backed up, if necessary, by a consultation with a small business legal or tax adviser, as discussed in Chapter 8).



RESOURCE

Get general business information. This book can't possibly cover all the ins and outs of small business law. For minute forms for holding and documenting LLC meetings, together with standard legal, tax, and business resolutions to insert in your LLC minutes, see *Your Limited Liability Company: An Operating Manual*, by Anthony Mancuso (Nolo). You'll find a wealth of helpful information in *Legal Guide for Starting & Running a Small Business*, by Fred S. Steingold (Nolo). For tax guidance, see *Tax Savvy for Small Business*, by Frederick W. Daily (Nolo).

If You Converted an Existing Business to an LLC

If you converted an existing sole proprietorship or partnership to an LLC, you'll need to take a few extra steps, as discussed in this section. (The aftermath of converting a corporation to an LLC is beyond the scope of this book.)



SKIP AHEAD

If yours is a new business. If you did not convert a preexisting business to an LLC, skip to "Basic Tax Forms and Formalities," below.

Notifying Agencies and Businesses

Make sure you notify the IRS, your state taxing authority, and other governmental agencies that you've changed your legal status to an LLC, and provide them with your new LLC name. As part of this process, you may need to obtain some of the following in your new LLC name:

- federal employer identification number (see the IRS website for information, at www.irs.gov)
- state employer identification number
- fictitious or assumed business name statement if you run your LLC under a name different from its formal name listed in its articles
- sales tax permit
- business license, and
- professional license or permit if the LLC members engage in a licensed profession.

Of course, you'll want to immediately get to work changing your stationery, business cards, brochures, advertisements, signs, and other marketing and business miscellany to reflect your new LLC name. In addition, let your bank, suppliers, customers, and business

associates know your new business name and LLC status.



TIP

Review your files and other papers for organizations to contact. If you go through the tax returns and other papers for your prior business, you'll likely discover the names and addresses of additional agencies and businesses that should be notified of your new business name and form.

Converting a Partnership to an LLC

If you converted an existing general or limited partnership to an LLC, you will probably need to do a little extra paperwork to end the legal existence of the partnership. If you neglect to take these steps, the general partner(s) may remain personally liable for any unpaid partnership business debts (we assume your LLC will pay off any unpaid debts of the prior business anyway; see “Liability for Previous Partnership Debts,” below).

- **Converting a general partnership to an LLC.** State law may require you to publish a notice of dissolution of partnership. Call a local paper that publishes legal notices and ask if it provides this service. Not only should the newspaper be able to tell you whether this notice is required in your state, it should be able to mail you a summary of your state's requirements if you want to read them yourself. When you publish your notice, the newspaper should send you a copy of the published notice and an affidavit of publication to place in your files.
- **Converting a limited partnership to an LLC.** This conversion usually is not legally effective until you file a cancellation or termination of limited partnership form with your Secretary of State's office. The state filing office should have a fill-in-the-

blanks or sample form you can use for this purpose, similar to the sample provided for Ohio, below (Certificate of Limited Partnership Cancellation). Your LLC filing office will normally handle the filing for terminating a limited partnership. You generally must attend to this formality unless your state LLC office supplied a special form of articles of conversion to convert a partnership to an LLC. In this latter case, the articles of conversion normally also legally terminate the existence of the limited partnership, so you don't have to separately file a termination or cancellation of limited partnership form.

Liability for Previous Partnership Debts

If your general or limited partnership has outstanding claims or debts owing at the time of its conversion to an LLC, the general partners of the preexisting partnership will remain personally liable for these debts. Of course, your new LLC probably plans to assume and pay these bills as they come due. As a courtesy, and to make sure all partnership creditors have personal notice of your new business structure, we recommend you send a personal letter to notify each one of the conversion of the partnership to an LLC, and provide the LLC's name and business address where future correspondence may be sent.

If there are significant disputed debts or claims of your prior partnership that your LLC will not automatically pay when it begins doing business, we strongly urge you to check with a business lawyer. You will obviously want to know your legal rights and responsibilities as to these disputed amounts.

Sample Cancellation of Limited Partnership

Form 563 Prescribed by the:
Ohio Secretary of StateCentral Ohio: (614) 466-3910
Toll Free: (877) SOS-FILE (767-3453)www.sos.state.oh.us
Busserv@sos.state.oh.us

Expedite this form: (select one)

Mail form to one of the following:

PO Box 1390
Columbus, OH 43216☐ Expedite

*** Requires an additional fee of \$100 ***

PO Box 1329
Columbus, OH 43216☐ Non ExpediteCertificate of Limited Partnership Cancellation /
Limited Partnership Cancellation Amendment
Filing Fee: \$50

(CHECK ONLY ONE (1) BOX)

(1) ☐ Limited Partnership Cancellation☐ Foreign (132-FPC)☐ Domestic (133-LPC)(2) ☒ Limited Partnership Cancellation
Amendment (101-LPN)

Name of Limited Partnership _____

Registration Number _____

Complete the information in this section if Foreign is checked in box (1)

A Foreign Limited Partnership, formed under the laws of the jurisdiction of _____

and registered to transact business in Ohio on _____ certifies that said Foreign
Partnership is no longer transacting business in Ohio and hereby states that said Foreign Limited
Partnership surrenders its authority to transact business in Ohio.

Complete the information in this section if Domestic is checked in box (1)

The date of the first filing of the certificate of limited partnership _____
DateAnd if different, the date of the first filing by the partnership with the secretary of state pursuant to Ohio Revised
Code Section 1782.63 _____

Date

Reason for filing certificate of cancellation

Filing a Bulk Sales Notice

Some states require the publication and mailing of a Notice of Bulk Sales when certain types of businesses—such as retail, wholesale, and manufacturing businesses—are sold or converted to another form. The idea behind the requirement is to prevent debtor businesses (those owing money when they “go out of business”) from changing their business form without arranging to pay their debts.

A local paper that publishes legal notices should know the rules for making this publication if it is required in your state. Ask the newspaper for a copy of your state’s bulk sales act rules if you want to read them yourself. If the newspaper can’t help you, a business or law library should have information and forms that you can use to handle any state requirements.



TIP

Your conversion to an LLC may be exempt from notice of bulk sales rules. In many states, bulk notice requirements are simplified or even waived if a business is simply being converted to a new form—such as the conversion of a partnership or sole partnership to an LLC—and the new business will assume and pay off the prior business’s debts.

Basic Tax Forms and Formalities

Let’s look at some tax issues and tasks you will need to keep in mind and tend to when the time comes.

Federal Income Taxes

If you wish your LLC to start out being treated by the IRS as a corporation, make sure to file IRS Form 8832 on time (within 75 days of the formation of your LLC). A tear-out Form 8832

is provided in Appendix B, and can be found on the IRS website at www.irs.gov. For further information, see Chapter 3.

If your LLC is classified as a partnership or a corporation (and not as the sole proprietorship of a sole member), it will need to file partnership or corporate tax returns each year. If it is classified as a partnership, make sure to provide Schedule K-1s to each member after the close of the LLC tax year as well.

Tax Resources for LLCs

Like many small business owners, you may plan to turn your annual tax preparation work over to your tax adviser, rather than handle it yourself. But you should still keep yourself informed of tax matters.

Whether you plan to prepare your own tax returns or simply want more information, you’ll want to take advantage of the free tax forms and publications provided by the IRS. Go to www.irs.gov and download the forms and publications, or call 1-800-TAX-FORM and request copies of:

- IRS Form 1065, *U.S. Return of Partnership Income*
- Schedule K-1 of Form 1065, and
- IRS Publication 334, *Tax Guide for Small Business*. This is one of the best guides for finding and filling in the latest annual tax return form for different types of businesses, including LLCs (which are treated as partnerships).

State Income Taxes

Most states follow the federal lead and classify your LLC the same as the IRS does. This normally (but not always) means the LLC

doesn't pay any entity (business) level state income tax (unless you elect to have your LLC classified and taxed as a corporation). The LLC may still have to file a state informational return, or annually submit a copy of the federal partnership tax return.



SEE AN EXPERT

Some states don't impose corporate or personal income taxes. Check your state's tax website (see Appendix A) or consult with your tax adviser if this issue is important to you.

Being treated as a partnership in a state without a personal income tax ordinarily means that the LLC and its members do not pay state income tax on LLC profits. However, don't forget that even if your LLC and members avoid income taxes on profits earned in your state, out-of-state taxes may be imposed if profits are earned in other states. This is a technical issue, and subject to state-by-state variations.

Some state tax offices require LLCs to pay a minimum annual tax each year, sometimes called an LLC "renewal fee." Some states go whole hog and subject LLCs to the same income or franchise tax that is levied on corporations.

If your LLC must pay state franchise or income tax, make sure you make required estimated payments. Franchise and income taxes must usually be prepaid in four installments during the tax year, with the first payment consisting of any minimum amount charged. If you miss estimated tax payments, you will be charged penalties and interest. In some states, your LLC can be suspended if you fail to pay these taxes for a few years.

Again, the best sources for current information on how your state handles the

income taxation of LLCs are your state tax office website and your tax adviser.

Employment Taxes

Your LLC will need to register as an employer. For salaried workers, your LLC must withhold, report, and pay:

- federal and, if applicable, state income taxes
- federal employment taxes (unemployment, Social Security, and Medicare taxes), and
- state payroll taxes (state unemployment, disability, and workers' compensation insurance).

And don't forget, LLC members may have to pay self-employment taxes on their allocated share of your LLC's profits—see Chapter 3 for more information.



RESOURCE

Get more information on federal payroll tax requirements. Go to www.irs.gov or call 1-800-TAX-FORM and download or request IRS Form SS-4 (to get a federal employer identification number for your LLC), IRS Publication 15, *Circular E, Employer's Tax Guide*, and the IRS Publication 15 supplements (for federal payroll tax information). For state payroll tax requirements, go to the state tax office online (typically, the Department of Revenue) or call the state tax office at its main information number (see Appendix A to locate online information) and ask to be transferred to the state employment tax division.

Other State and Local Taxes

State sales, use, and county property taxes apply to LLCs. Counties and cities also may impose local and regional taxes. Check with your county and city tax offices for current information.

Ongoing LLC Legal Paperwork and Procedures

Now let's cover a few legal formalities that may come up during the life of your LLC.

Changing Your Operating Agreement

During the life of your LLC, you may want to make changes to your operating agreement or draw up a new agreement—for example:

- If a new member joins the LLC, you will want a new agreement to include the new member's capital, profits and losses, and voting percentages.
- A prospective new member, or his or her legal or tax adviser, may ask for a change to one or more provisions in your old agreement to suit the needs of the new member.

Of course, you can decide to update your operating agreement at any time, not just when a new member joins your LLC. It's a good idea to sit down with your fellow LLC members at least once every two or so years and go over your agreement to see if it continues to meet your needs. If it doesn't, perhaps it is time to make a few changes.

EXAMPLE:

The Pig in a Poke Ltd. Liability Company, a mail-order lottery subscription and award notification service, wants to enlarge its membership base. The current members reason that it will be easier to attract new LLC members if they can be allowed to transfer their membership to others more easily than their operating agreement currently allows. They meet and decide to lessen the unanimous vote requirement in their agreement to allow transfers to new

members by a per capita majority vote of the members. They then amend their operating agreement to reflect this change.

How to Update Your Operating Agreement

There are three steps to updating an LLC operating agreement:

- First, have your members formally meet, discuss, and approve the changes you plan to make to the operating agreement.
- Next, prepare a new operating agreement. Simply recreate your old agreement, revising it to reflect your LLC's new needs.
- Finally, have all members and their spouses sign the updated operating agreement, which contains the new provisions plus all unchanged provisions carried over from your previous agreement.



CAUTION

Watch out for state law restrictions on changes to your agreement. Your state's LLC act may contain restrictions or requirements. For example, some states prevent you from lowering the voting requirements necessary to amend the articles or certificate of organization.

How to Prepare a New Agreement for a New Member

As we've said, preparing and signing a new LLC operating agreement ensures each new member agrees to all rights and responsibilities of LLC membership and that each current member agrees to the new division of capital, profits, losses, and voting.

When you prepare a new operating agreement, make sure to change the capital contributions clause and other provisions that are affected by admitting the new member. All

current members plus the new member must sign the new agreement. Place the original in your LLC records book.

EXAMPLE:

Shortly after its formation, Tried & True Triad Music Promotions LLC, a three-owner company, decides to admit a fourth member. The new member will pay \$20,000 to the LLC, the same amount each of the original members paid. The company adopts a new operating agreement and changes the ownership percentages of the original three members in the capital contribution clause from 33⅓% to 25%, also showing a 25% interest for the newly admitted fourth member. No other changes are required, because splitting of profits and losses and voting rights follow the percentage interests shown in the capital contributions clause. The three initial members and the new member sign the new agreement and place it in the LLC records book.



CAUTION

Get tax advice. Adding a new member is one of the times when tax help may be needed to make important LLC tax elections. For example, a tax election may be necessary to make sure that the relative capital accounts balances of the original members are adjusted to properly reflect their correct ratios after the admission of a new member.

LLC Meeting Requirements

Most states do not impose strict requirements on LLCs in terms of how or how often the members or managers meet. State LLC acts usually allow the LLCs' articles of incorporation or operating agreements to set forth meeting requirements and procedures. We found the two following unusual exceptions: Minnesota and North Dakota both require that, should the members choose to act in place of the Board of Governors (the managers), they must act by unanimous vote. (Minnesota Statutes Section 322B.606 and North Dakota Statutes Section 10-32-69).

Minutes of Meetings

If your LLC wishes to approve and formally document an important legal, tax, or business transaction, you'll normally hold a meeting of your members (or managers, if you have opted for manager control by adopting the operating agreement covered in Chapter 6).

Your members or managers may decide to hold a formal LLC meeting to take actions such as the following:

- vote on any matters that require a membership (or manager) vote, as set out in your operating agreement
- change your LLC operating agreement (even in manager-managed LLCs, the members normally are asked to ratify any changes to the operating agreement)
- amend the LLC's articles of organization
- make significant capital outlays, such as to purchase real property
- fund a major, recurring LLC expense, such as contributions to an employee pension or profit-sharing plan
- sell real estate or other major capital items

- sell or purchase an operating division within the company, or expand or discontinue a product line or services
- pursue or settle a lawsuit, or
- approve other important legal, business, financial, or tax decisions.

You should prepare minutes of formal LLC meetings during or after the meeting, recording the discussions and decisions made. After the meeting, place the signed minutes in your LLC records book.



TIP

You don't always have to meet face-to-face to record a formal LLC decision. Even if your LLC operating agreement requires that all or a certain percentage of members or managers approve a particular decision formally, you don't usually need to get together in person to do so. You may hold meetings on paper if all members or managers agree. You do this by preparing minutes that record a decision as though it had been made at a formal meeting. You then circulate these minutes for formal approval (signing and dating) by each member or manager. This sort of "paper meeting" is fine if everyone agrees to approve a decision this way.

Give Adequate Notice of Meeting to All Members or Managers

We don't cover all the ins and outs of calling, providing notice of, and holding formal LLC meetings in our standard operating agreement. Most state laws are very flexible and allow LLCs to handle these matters in any way the members or managers wish. If, however, you have specified meeting rules in your operating agreement or articles of organization, make sure you follow them.

To make sure everyone involved knows the time, date, and purpose of each upcoming meeting, notify all members or managers (or

both groups if both will attend the meeting) well in advance. Normally, two to four weeks' mailed notice is adequate. Providing adequate notice is particularly important if some members are not active in the LLC and not part of your LLC's normal network of memos, discussions, and verbal feedback. Taking the extra step to provide notice of an upcoming meeting may not be legally necessary under your operating agreement or state law, but it can avoid a lot of aggravation later—for example, if a controversial decision is adopted at a meeting without the approval of one or more members or managers.



RESOURCE

See *Your Limited Liability Company: An Operating Manual*, by Anthony Mancuso (Nolo), for a comprehensive treatment of LLC meetings, with tear-out and CD-ROM minutes forms plus more than 80 resolutions to show approval of various legal, tax, and business transactions by LLC members and managers.

How to Complete Minutes of Meeting Form

On the next page, we provide a sample of the simple, ready-to-use LLC Minutes of Meeting form included in Appendix B. You can make a copy of the tear-out form and fill it in as you follow the sample and instructions, or use the form on the CD-ROM.



FORMS

Where to find forms in this book. If you're reading a print copy of this book, you'll find copies of the LLC Minutes of Meeting form on the CD-ROM that comes with the book. If you're using an eBook version, you can download this form on the Nolo website; the link is included in Appendix C. Both the print copy and eBook versions include tear-out versions of the forms (found in Appendix B) and filled-in samples in the text.

Minutes of Meeting of the_____
["Members" or "Managers"] ❶

of

[Name of LLC]

A meeting of the _____ ["members" or "managers"] of the above named limited liability company was held on _____ [date, including year], at _____ [time] _____ m., at _____ [address], State of _____ [state], for the following purpose(s):
 _____ [list the items of business discussed or considered by the members or managers] ❷

 [name and title] acted as chairperson, and
 [name and title] acted as secretary of the meeting. ❸

The chairperson called the meeting to order.

The following _____ ["members" or "managers"] were present at the meeting:
 _____ [names of members or managers] ❹

The following persons were also present at the meeting, and any reports given by these persons are noted next to their names below: ❺

Name and Title _____	Reports Presented, If Any _____
_____	_____
_____	_____
_____	_____

After discussion, on motion duly made and carried by the affirmative vote of _____ ["all," "a majority of the percentage interests," or whatever voting requirement is used for members or managers in your LLC] of the _____ ["members" or "managers"], the following resolution(s) was/were adopted:
 _____ [insert language of proposal(s) passed by members or managers] ❻

There being no further business to come before the meeting, it was adjourned on motion duly made and carried.

Date: _____ [date]

Signature(s): _____ [signature of LLC Secretary, officer, or member]

Name: _____ [typed or printed name] ❼

Title: _____ [LLC title or status]

Special Instructions for Minutes of Meeting

❶ In the first blank, indicate whether the minutes are being prepared for a meeting of members or managers. Because most smaller LLCs are managed by members, formal meetings will usually be convened as membership meetings.

❷ Include a brief statement of the nature of the resolutions that are raised for approval at the meeting. For example: “to approve the purchase of property by the LLC” or “to approve a proposed employment contract to be offered to the CEO of the LLC” or “to accept the terms of a construction loan obtained by the treasurer of the LLC.”

❸ Insert the name and title of the persons designated as chairperson and secretary of the meeting. Normally, the CEO or president of the LLC acts as chairperson. The person preparing these minutes will typically be the secretary of the meeting (often the secretary of the LLC).

If you have not designated officers for your LLC (see Special Instruction ❷ in the operating agreement instructions in Chapter 5), simply appoint one of the attending members or managers to serve in each of these capacities.

❹ This paragraph indicates which members or managers attended the meeting. Check your operating agreement to see if it states that a minimum number of members or managers must attend meetings—technically, this number is called a “quorum.” Our standard operating agreement provisions require:

- **Member-managed LLC:** All members must attend meetings unless a nonattending member agrees in writing prior to the meeting that it may be held in his or her absence (or unless the meeting is a second postponed meeting; see Chapter 5, Special Instruction ❶).

- **Manager-managed LLC:** You may pick the number of managers who must attend an LLC managers’ meeting—see Chapter 6, Special Instruction ❶).

❺ List any nonmembers or nonmanagers who attend the meeting. Also show to the right of an attendee’s name any report presented by this person (such as an “annual written financial report by the LLC treasurer,” “an insurance availability and premium quote report by a vice president,” or “an oral report by the president on the negotiations that led to the drafting of a proposed lease agreement being presented at the meeting for approval by members”). Attach to your minutes a copy of any written reports handed out at the meeting.

❻ Here you take care of the primary reason for preparing minutes of your meeting: to show the vote taken and the language of the proposals approved by your members or managers. If different votes are obtained on different resolutions, repeat this preliminary paragraph before each resolution.

LLC members are normally given voting power equal to their percentage interests in the LLC. So, for example, a member who owns 25% of the LLC will normally have 25% of the voting power of the LLC. Managers, on the other hand, normally are given one vote per person in reaching management decisions. Check your operating agreement to be sure of your voting rules for members and managers.

Show the vote obtained in favor of the proposal in the first blank. For more significant or controversial decisions, where members or managers dissent or abstain, you may wish to insert a paragraph that shows how each person voted on every individual proposal—for, against, or abstained.

**CAUTION**

On special matters, your operating agreement may have stricter voting requirements.

For example, unanimous voting approval of members or managers may be required for:

- the approval of structural changes to the LLC, such as a sale of assets
- the admission or departure of members
- continuance or dissolution of the business after a member leaves, or
- amendments to the articles of organization.

In the last blanks of the paragraph, insert the wording of each resolution approved at the meeting. The language should be nontechnical and clearly state the decision the members or managers reached. If you wish to back up your description, you can attach additional information to your minutes and refer to the attachments here.

Example of Contract Approval: “The members approved a long-term contract for the supplying of goods to the LLC by [name of company]. A copy of the contract approved is attached.”

Although routine business contracts are normally not formally approved at a membership meeting, such approval may be sought to avoid the appearance of a conflict of interest—for example, if the supply company is owned or managed by a member’s spouse.

Example of Lease Approval: “The managers approved the terms of a ten-year lease of premises by the LLC. A copy of the lease agreement is attached.”

Approval of Tax Matter: “The members approved the following tax proposal, recommended for passage by the LLC’s accountant, [name of accountant]. Copies of correspondence with the accountant and other relevant documents considered by members before approval of this proposal are attached.”

7 Have the secretary of the meeting, or any other designated LLC officer or member, date and sign the minutes. Type or print the person’s name and title under the signature line. Finally, place a copy of the signed minutes in your LLC records book together with any attachment pages.

Special Approvals for New or Departing Members

When a member joins or leaves an LLC, it is important to comply with the voting requirements in the LLC’s operating agreement, especially if state law sets the requirements.

Check Vote Required to Approve Transfer or Continuance of LLC

You’ll need to determine who has to vote, when, and the number of votes needed to approve the transfer of membership by a former member to a new member, or to continue the existence of the LLC after a member dies, retires, resigns, goes bankrupt, becomes mentally incompetent, or is expelled.

The accompanying sidebar, “Standard Voting Requirements in Our LLC Operating Agreements,” lists the requirements for these two formal matters under provisions in our tear-out operating agreements in Appendix B.

Standard Voting Requirements in Our LLC Operating Agreements

Here's how our two operating agreements address voting requirements for these two important LLC matters:

Continuance of LLC After Dissociation of a Member

- **Who votes:** Remaining members
- **When:** Typically within 90 days of dissociation of member
- **Vote required:** Typically, approval by all remaining members
- **Where to look for more information:** Chapter 5, Special Instruction 38

Transfer of Membership by Former Member to New Member

- **Who votes:** Typically, nontransferring members
- **When:** Varies; see your operating agreement
- **Vote required:** Typically, approval by all nontransferring members
- **Where to look for more information:** Chapter 5, Special Instruction 36

Prepare Minutes Approving Transfer of Membership or Continuance of LLC

Once you know the voting rules you must follow, hold a meeting and obtain the required membership (or member-manager) approval. Then prepare written minutes of the meeting to place in your LLC records book.

Below is language you can use in your minutes to show the approval of either of these formal matters at a membership or member-manager meeting:

Special Instruction for Language Approving Transfer of Membership or Continuance of LLC

❶ If your agreement requires (as ours do) a per capita vote to approve these special matters (this means a simple head count for each member or member-manager), leave this “LLC Interest” column blank.

If your operating agreement requires voting approval of these matters by capital and/or profits interests in the LLC, indicate in this column the appropriate percentage(s) for each member. If, for instance, your agreement requires a majority of the LLC's capital and profits interests to approve the continuance of your LLC after a member resigns, you would fill out this column to show these two percentages for each remaining member who attends the meeting and votes. For example, if a remaining voting member holds both a 50% capital and profits interest in your LLC, this column would state “50% capital and 50% profits interest” for the member.

Prepare New Operating Agreement

Follow the instructions in “Changing Your Operating Agreement,” above, and have all members (old and new) sign the new agreement.

Keep LLC Records

You will want to keep your important LLC documents in a safe, convenient place. We recommend setting up an organized system for keeping your LLC records, whether in manila envelopes, file folders, or a specially ordered LLC records book available from legal stationers. For minute forms for holding and documenting LLC meetings, together with standard legal, tax, and business resolutions to insert in your LLC minutes, see *Your Limited Liability Company: An Operating Manual*, by Anthony Mancuso (Nolo).

Sample Language for Approving Transfer of Membership or Continuance of LLC

Sample Language: The members of _____ *[name of LLC]* met to approve the _____ *["transfer of membership by (name of former member) to (name of new member)" or "continuance of the LLC following the (insert dissociation event, such as "resignation," "retirement," "death," "bankruptcy," "mental incompetence," or transfer of membership or dissociation of member)"]* _____, which occurred on _____ *[date of transfer of membership or dissociation of member]* _____. The _____ *["nontransferring" (use this word to approve transfers) or "remaining" (use this word instead to approve a continuance of the LLC)]* _____ *["members" or "member-managers"]* _____ of the LLC voted to approve the matter by the following vote:

Name of Member	LLC Interest ❶	Vote
_____ <i>[list each nontransferring or remaining member]</i>	_____	_____ <i>["approve," "against," or "abstain"]</i>

Other Ongoing LLC Formalities

In this section, we cover a number of additional ongoing legal, tax, and practical formalities that apply to LLCs.

How to Sign Papers on Behalf of Your LLC

We're sure the separate legal existence of your LLC is important to you, particularly to avoid personal liability for business debts and claims. To make sure you and other LLC members will enjoy this limited liability, members should always sign LLC papers, documents, contracts, and other commitments clearly in the name of the LLC, not in their own names.

The best way to do this is to first state the name of the LLC, then sign your name on its behalf.

EXAMPLE:

Tom is one of two members of Park Place Plasterers, Ltd. Liability Co. He enters into a long-term contract to refurbish apartments in a high-rise condominium. Tom signs the contract as follows:

Date: November 3, 20xx
 Park Place Plasterers, Ltd. Liability Co.
 By: _____ *[Tom's signature]* _____,
 Tom Park, LLC Member/Manager



CAUTION

Signing in your own name could lead to personal liability. If you don't follow our advice, the other party to a contract you sign may be able to hold you personally liable. To avoid confusion and legal problems, make this simple signing procedure a regular part of your day-to-day business routine.

File Annual State LLC Reports

Most states require LLCs to file simple annual reports, and many can be prepared and filed online from the LLC filing office website.

You usually need to provide minimal information on this form, such as the names and addresses of current LLC members and/or managers, and the name and address of the LLC's registered agent and office for service of legal process. Often, you can leave items blank if there is no change in the information from the previous annual report filing.

Typically, you must mail a small fee with the form, in the \$10 to \$50 range. See your state's filing office website for current annual filing fee information.

Filing a Fictitious or Assumed Business Name Statement

You may wish to operate your LLC locally under a name that's different from the formal name of your LLC listed in your articles of organization.

EXAMPLE:

The Solar Plexus Flex and Fitness Center Ltd. Liability Co. decides to operate its three franchise locations under the fictitious name Flex and Fitness Center. The LLC owners want to continue to keep the formal name stated in the state-filed LLC articles of organization, but prefer operating their fitness centers under this second, shortened version.

Most states let you use a new name by filing a fictitious or assumed business name statement form and paying a small fee. You normally file this paperwork with the Secretary of State's

office or the local county clerk or another county office. In some states, both a state and county filing are required. Find out your state's rules by checking your state's LLC filing office website or calling your Secretary of State's or your local county clerk's office.

Some states also require that a notice of use of, or intention to use, the fictitious name be published in a newspaper of general circulation one or more times in each county where the name is or will be used. Newspapers with legal notice classified sections will do this for you for a moderate fee and file any statements of publication required under your state's fictitious business name statute. The easiest way to find out if your state requires publication, and what the requirements are, is to call a local newspaper.

Amending Articles of Organization

Your original LLC articles of organization contain basic information and ordinarily will stay the way they are for a long time to come. But if you need to make a major change to your LLC that alters the information in this document—such as changing the formal name of your LLC or changing whether your LLC is managed by members or managers—you will need to file amended articles with your state's LLC filing office. The filing fee for amended articles is typically the same as the fee paid to file original articles of organization.

Most LLC filing offices provide an amendment form online, which you can fill in—usually an easy task. On the following page is a standard amendment form (in this case, for Connecticut), typical of the type of filing necessary to register amendments to LLC articles of organization with the state.

MAILING ADDRESS: COMMERCIAL RECORDING DIVISION, CONNECTICUT SECRETARY OF THE STATE, P.O. BOX 150470, HARTFORD, CT 06115-0470
DELIVERY ADDRESS: COMMERCIAL RECORDING DIVISION, CONNECTICUT SECRETARY OF THE STATE, 30 TRINITY STREET, HARTFORD, CT 06106
PHONE: 860-509-6003 **WEBSITE:** www.concord-sots.ct.gov

C.G.S. §§34-109; 34-122

USE INK. COMPLETE ALL SECTIONS. PRINT OR TYPE. ATTACH 8 1/2 X 11 SHEETS IF NECESSARY.

PAGE 1 OF 1

Sample Change of Registered Agent or Address

 State of Tennessee Department of State Corporate Filings 312 Rosa L. Parks Avenue 6th Floor, William R. Snodgrass Tower Nashville, TN 37243 CHANGE OF REGISTERED AGENT/OFFICE (BY A LIMITED LIABILITY COMPANY)	<i>For Office Use Only</i>						
Pursuant to the provisions of §48-208-102(a) of the Tennessee Limited Liability Company Act or §48-249-110(a) of the Tennessee Revised Limited Liability Company Act, the undersigned Limited Liability Company hereby submits this application:							
1. The name of the Limited Liability Company is: _____ _____							
2. The street address of its current registered office is: _____ _____							
3. If the current registered office is to be changed, the street address of the new registered office, the zip code of such office, and the county in which the office is located is: _____ _____							
4. The name of the current registered agent is: _____ _____							
5. If the current registered agent is to be changed, the name of the new registered agent is: _____							
6. After the change(s), the street addresses of the registered office and the business office of the registered agent will be identical.							
<table style="width: 100%; border: none;"> <tr> <td style="width: 50%; border-bottom: 1px solid black; padding-bottom: 5px;">Signature Date</td> <td style="width: 50%; border-bottom: 1px solid black; padding-bottom: 5px;">Name of Limited Liability Company</td> </tr> <tr> <td style="border-bottom: 1px solid black; padding-bottom: 5px;">Signer's Capacity</td> <td style="border-bottom: 1px solid black; padding-bottom: 5px;">Signature</td> </tr> <tr> <td></td> <td style="border-bottom: 1px solid black; padding-bottom: 5px;">Name (typed or printed)</td> </tr> </table>		Signature Date	Name of Limited Liability Company	Signer's Capacity	Signature		Name (typed or printed)
Signature Date	Name of Limited Liability Company						
Signer's Capacity	Signature						
	Name (typed or printed)						
SS-4225 (Rev. 01/06) Filing Fee: \$20 RDA 2458							

**CAUTION**

Hold a formal membership meeting to approve amendments. Before filing an amendment with the state, your membership should approve any amendment to the LLC's articles of organization at a formal meeting. See "Minutes of Meetings," above, on how to prepare minutes of an LLC meeting.

Changing Registered Agent or Office

The initial registered agent and registered office of your LLC are usually specified in your articles of organization. The registered agent is the person your LLC authorizes to receive legal documents from the state as well as the public on behalf of the LLC. The registered office is the business address of the agent where legal papers may be served.

It's in your LLC's best interests that the state has the most current registered agent and office information—you don't want to miss any important legal papers sent by the state to an old address. Moreover, if you change the name or address of the registered agent, you are normally required to notify the state. In most states, the LLC filing office provides a standard form (titled "Change of Registered Agent or Address" or something similar) online (see the sample for Tennessee, below). There may be a small filing fee.

Note that the change of registered agent or office is a routine task so you don't need to hold a formal LLC meeting, amend your articles of organization, or revise your operating agreement. Just fill in and file the state-supplied form—that's all there is to it.

Certification of LLC Existence

Outside businesses, financial institutions, creditors, and individuals may want to see formal legal paperwork that establishes the

existence of your LLC before deciding to transact other business with it (enter into a contract, sign a lease, agree to sell or buy property, and the like). Normally, a copy of your articles of organization or operating agreement sufficiently establishes that your LLC has handled all the necessary organizational formalities.

Occasionally, you may have to be even more formal and show a *certified* copy of your LLC articles of organization. A certified copy, which should be available for a small fee from your state LLC filing office, may not show only the file stamp of the office, but also formal language stating that your LLC has met all necessary state formalities to begin doing business in your state.

Some outsiders may be sticklers for detail and insist that you show them that your legal status is still valid—after all, articles of organization and operating agreements only show that you met legal requirements on a past date. Most states will help you with this. One way is to call the status or legal section of the LLC filing office and ask if you can obtain a current certificate of status or good standing for your LLC. Some states provide a standard certification form, which shows your LLC meets all state legal and tax requirements on the date of the status request.

Certification of Authority of LLC Members or Officers

It's possible that an outsider may raise a question about the legal authority of your LLC members, managers, and/or officers, and want to be sure they really have official status or specific authority for a transaction before proceeding. Typically, this occurs with real estate transactions involving title (and escrow companies that are paid to be fussy), particularly if the property is located in another state.

Complying with a request of this sort involves more than simply checking the legal status of your LLC, as discussed above. You also will need to document that the person acting on behalf of the LLC is properly authorized by the LLC to enter into the transaction. There are a few ways to handle this, as discussed in detail below, namely by providing a:

- copy of your articles of organization
- copy of your operating agreement
- certification of authority, or
- state certification form.

Let's look at each of these options.

Copy of Articles of Organization

In most states, your articles of organization list the *initial* members of your LLC and state whether the members will manage the LLC. If your LLC has adopted a manager-managed operating agreement, these individuals should be listed as managers in your articles of organization. To obtain certified copies of articles of organization (available for a small fee), contact your state LLC filing office—see Appendix A for information on locating your state's office online.

Copy of Operating Agreement

If you need to certify the authority of a member or manager who assumed this role after your articles of organization were filed, you can provide a copy of the amended operating agreement signed by the new member or manager.

Certification of Authority

If you want to keep your operating agreement private, an alternative approach is to prepare a simple form to certify the authority of any members or managers. We include a Certification of Authority in Appendix B for this

purpose. Below is a sample of this form, along with instructions.



FORMS

Where to find forms in this book. If you're reading a print copy of this book, you'll find copies of the Certification of Authority form on the CD-ROM that comes with the book. If you're using an eBook version, you can download this form on the Nolo website; the link is included in Appendix C. Both the print copy and eBook versions include tear-out versions of the forms (found in Appendix B) and filled-in samples in the text.

Special Instructions for Certification of Authority

❶ Here is a specific designation of authority you can fill in to underscore the member's or manager's authority to transact specific business for your LLC. In the blanks, describe the specific transaction for which the certification is being sought, such as:

- “the signing of a lease for the premises located at [address]”
- “entering into a contract with [name of company or individual] for [specify product or services under consideration]”
- if you don't want to limit the person's authority in any way, “any and all LLC business,” or
- if you don't want to complete this blank, insert “N/A” instead.

❷ You can have your LLC secretary, president, or another designated officer prepare and sign this form, or you can have it signed by all current LLC members or managers. These signing procedures are authorized under the standard provisions in the tear-out operating agreements included in this book. (See Chapter 5, Special Instruction ❹.) Simply fill in the appropriate title, such as “Secretary,” “President,” “Member,” or “Manager.”

Sample Certification of Authority

This LLC is managed by its ["members" or "managers"]. The names and addresses of each of its current ["members" or "managers"] as of [date of certification] are listed below. Each of these persons has managerial authority of the LLC and is empowered to transact business on its behalf.

Name of <u>["Member" or "Manager"]</u>	Address
_____	_____
_____	_____
_____	_____
_____	_____

Further, each of the following ["members" or "managers"] is specifically authorized to transact the following business on behalf of the LLC:

[describe the specific business transaction] ① .

Date: [date of signing—on or after certification date shown above]

Name of LLC: [name of LLC]

By: [signature]

Name: [typed or printed name of signer]

Title: [LLC title or status] ②

State Certification Form

Some states let you file a form with the state LLC filing office certifying the names and authority of your LLC members and/or managers. They do this because LLCs are a relatively new type of business and the state

recognizes that an official form may look better than an internal certification form provided by the LLC. To find out if your state has a form of this type, check your state website or call your state LLC filing office. ●

Lawyers, Tax Specialists, and Legal Research

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Much of the work involved in organizing and running an LLC (or other small business) is routine. One good way to learn more about tax matters and legal issues is to read up on them yourself. You've already taken a big step in this direction by using this book.

But there's no way around it—from time to time, you need help from outside sources. Quite likely, you will want to supplement your understanding of the legal and tax consequences of forming an LLC by asking a lawyer or tax professional to double-check your decisions and review your paperwork or advise you on complex areas of law or taxation. At times, you may want to run important business decisions by an experienced adviser who has a mix of business, tax, and legal savvy.

Throughout this book, we have flagged instances where a lawyer or tax adviser can provide valuable assistance, such as to:

- review the legal options in your operating agreement
- add special provisions to satisfy the IRS if you will split profits and losses among members disproportionately to capital contributions, or
- customize buy-sell, or buyout, provisions.

In the sections below, we provide a few tips to help you locate a competent expert. Finally, if you want to do your own research, you'll find valuable suggestions on how to get started.



TIP

Consider joining one or more trade groups related to your business. These groups often track legislation in particular areas of business—such as LLC legal and tax developments—and provide sample contracts and other useful legal forms. Some also retain law firms for trade association purposes, and may be able to refer you to competent local lawyers.

Finding the Right Tax Adviser

You know that forming an LLC involves understanding and choosing among various tax options. Among these technical issues is finding out whether it makes sense to elect corporate tax treatment with the IRS.

Other LLC business decisions involve tax issues and advice as well: understanding how your state treats LLCs for state income tax purposes; selecting a tax year and accounting period; setting up financial books and bookkeeping procedures; withholding and reporting payroll taxes; and preparing tax returns and schedules that allocate profits, losses, credits, and deductions among LLC members. To make informed decisions in these and other tax areas, you may need help from a tax adviser. Depending on the issue, this adviser may be a certified public accountant, financial or investment adviser, loan officer at a bank, pension plan specialist, or bookkeeper trained in employment tax reporting and return requirements.

The best way to find a knowledgeable and helpful tax adviser is to shop around for someone recommended by small business people whose judgment you trust. Your tax person should be available over the phone to answer routine questions and by mail or fax to handle paperwork and correspondence. It is likely that you will spend much more time dealing with your tax adviser than your legal adviser (discussed below), so be particularly attentive to the personal side of this relationship.

Tax issues are often cloudy and subject to a range of interpretations and strategies, particularly in the newish LLC legal arena, so it is absolutely essential that you discuss and agree to the level of tax aggressiveness you expect from your adviser. Some LLC owners want to live on the edge, saving every possible tax dollar. Others are content to forego contestable tax deductions to gain an extra measure of peace of mind. Whatever your tax strategy, make sure you find a tax adviser who feels the same way you do or is willing to defer to your more liberal or conservative tax tendencies.

It pays to spend some time learning about LLC and employment taxation. Not only will you have to buy less help from tax professionals, but you'll be in a good position to make good financial and tax planning decisions. IRS publications, business and law library materials, trade groups, and countless other sources provide a growing body of LLC tax information. Your accountant or other tax adviser should be able to help you get your hands on good LLC materials. (See the accompanying sidebar, "Resources for Tax and Financial Information.")

Resources for Tax and Financial Information

The Small Business Administration can be an ideal source of financial and tax information and resources (as well as financing, in some cases).

If you want to get copies of IRS publications, you can find them online at www.irs.gov or at your local IRS office, or you can order them by phone (call the toll-free IRS forms and publications request telephone number at 1-800-TAX-FORM).

- Start by obtaining IRS Publication 509, *Tax Calendars*, prior to the beginning of each year. This pamphlet contains tax calendars showing the dates for business and employer filings during the year.
- You can find further information on withholding, depositing, reporting, and paying federal employment taxes in IRS Publication 15, *Circular E, Employer's Tax Guide*, and the Publication 15 supplements. Also helpful is IRS Publication 334, *Tax Guide for Small Business*.
- IRS Publication 538, *Accounting Periods and Methods*, and IRS Publication 583, *Starting a Business and Keeping Records*, provide helpful information on accounting methods and bookkeeping procedures.

How to Find the Right Lawyer

Most small businesses can't afford to put a lawyer on retainer. Even when consulted on an issue-by-issue basis, lawyer's fees mount up fast—usually way too fast for all but the most pressing legal issues. Just as with individuals, more small businesses are trying to at least partially close this legal affordability gap by doing as much of their own legal research and form preparation as possible. This is one of the reasons we refer to various sections of your state's LLC act throughout the book—by spending a few minutes reading a section of your state's LLC act from time to time, you can save yourself lawyers' fees. Other times, it makes sense to consult briefly with a lawyer at an interim stage, or have your paperwork or conclusions reviewed, particularly for decisions that are complex or have significant legal consequences.

The “Legal Coach” Arrangement

Most readers will not want a lawyer who is programmed to take over all legal decision making and form drafting—this builds up billable hours that few can afford. Instead, we suggest you find someone we call a “legal coach”: a professional who is willing to work with you—not just for you—in establishing your LLC and helping with ongoing legal formalities. Under this model, the lawyer helps you take care of many routine legal matters yourself, while also being available to consult on more complicated legal issues as the need arises.

Not all lawyers will be comfortable with you taking an active role in your LLC's legal life, so you may need to interview several people before finding a compatible legal adviser. When you call a lawyer, announce your intentions in advance—that you are looking for someone who is willing to review your LLC operating agreement or to handle ongoing legal work

from time to time. Mention that you are looking for someone who is flexible, points you in the right direction as the need arises, serves as a legal adviser as circumstances dictate, and tackles particular legal problems if necessary. In exchange for this, let the lawyer know you are willing to pay promptly and fairly.

Some lawyers may find a legal coach model unappealing—for example, they may not feel comfortable reviewing documents you have drafted using self-help materials. If so, thank the person for being frank and keep interviewing other lawyers, unless you are willing and able to pay to have a lawyer do all the work for you.

When you find a lawyer who seems agreeable to the arrangement you've proposed, ask to come in to meet for a half hour or so. Expect to pay for this initial consultation. At the in-person interview, reemphasize that you are looking for a legal coach relationship. You'll also want to discuss other important issues in this meeting, such as the lawyer's customary charges for services, as explained further below. Pay particular attention to the rapport between you and your lawyer. Remember, you are looking for a legal adviser who will work with you. Trust your instincts and seek a lawyer whose personality and business sense are compatible with your own.



TIP

Look elsewhere for tax advice. When it comes to special tax questions, such as when and if you should elect corporate tax treatment with the IRS, we think a tax adviser with LLC experience is the best person to ask for help. For other tax and financial decisions, such as the best tax year, accounting period, or employee benefit plan for your LLC, you'll find that accountants, financial planners, pension plan specialists, and bank officers often have a better grasp of the issues than lawyers. And an added bonus is that although tax advice doesn't come cheap, it usually costs less than legal advice.

Why to Hire a Small Business Lawyer

In your quest for a lawyer, remember:

- **You don't need a big-time business lawyer.** Look for a lawyer with some small business experience, preferably in your field or area of operations. For the most part, you don't want a lawyer who works with big businesses (publicly held corporations, large limited partnerships, investment pools, and the like). Not only will this person deal with issues that are far from your concerns, the fees are almost sure to be too high.
- **You don't need a legal specialist.** What if you have a very technical legal question? Should you start by seeking out a legal specialist in an area such as insurance, banking, or securities law? For starters, the answer is probably no. First, find a good small business lawyer to act as your coach. Then rely on this person to suggest specialized materials or experts as the need arises. Again, finding a lawyer with LLC experience is helpful, but specialized legal involvement in narrower realms of business practice can wait until you actually need advice on a particular legal issue or problem.

How to Find a Lawyer

When you're ready to look for a lawyer, talk to people in your community who own or operate businesses of comparable size and scope. Try to get a personal recommendation of a knowledgeable and helpful lawyer. If possible, ask someone who has successfully formed an LLC for the name of the lawyer who helped get the LLC started and get an opinion of the lawyer's work.

If you talk to half a dozen business people, chances are you'll come away with several good leads. Other people, such as your banker,

accountant, insurance agent, or real estate broker, may also be able to provide the names of lawyers they trust to help them with business matters.

How shouldn't you search for a lawyer? Don't just pick a name out of a phone book or advertisement—you really have no idea of what you're getting. Lawyer referral services operated by bar associations are usually equally unhelpful. Often, these simply supply the names of lawyers who have signed onto the service, without independently researching the skills or expertise the lawyer claims to have.

What about looking for a lawyer online? Obviously, many lawyers have their own websites, and there are a number of online lawyer directories. Look for sites that do two things:

- **Provide in-depth biographical information about a lawyer.** You want to know where the lawyer went to school, how long he or she has been in practice, the lawyer's specialties, and whether the lawyer has published articles or books on small business law or is a member of relevant trade organizations.
- **Provide helpful information about how a lawyer likes to practice.** For example, if the biographical information states that the lawyer enjoys helping small business people understand the legal information they need to actively participate in solving their own legal problems, you may wish to set up an appointment.



RESOURCE

Check out Nolo's lawyer directory. Nolo maintains a lawyer directory on its website, www.nolo.com, which provides quite detailed profiles of listed lawyers. Although the directory doesn't yet cover the whole country, you can check whether there are lawyers listed in your area.

**CAUTION**

Don't wait until a legal problem arises before seeking out a lawyer. Even if you have all your LLC formation work covered, it's not too early to find a lawyer to use later for ongoing business consultations. Once enmeshed in a crisis, you may not have time to hire a lawyer at affordable rates. Chances are you'll wind up settling for the first person available at a moment's notice—almost a guarantee you'll pay too much for possibly poor service.

Set the Extent and Cost of Services in Advance

When you hire a lawyer, get a clear understanding about how fees will be computed. For example, if you call the lawyer from time to time for general advice or to be steered to a good information source, how will you be billed? Some lawyers bill a flat amount for a call or a conference; others bill to the nearest six-, ten- or 20-minute interval. Whatever the lawyer's system, you need to understand it.

How Lawyers Charge for Legal Services

You can expect your lawyer to bill you in one of these ways:

- **By the hour.** In most parts of the United States, you can get competent services for your small business for \$200 to \$300 an hour, and often less. Newer attorneys still in the process of building a practice may be available for paperwork review, legal research, and other types of legal work at lower rates. However, they may take longer to complete these tasks, as well.
- **Flat fee for a specific job.** Under this arrangement, you pay an agreed-upon amount for a given project, regardless of how much time the lawyer spends. Particularly when you begin working with a lawyer and are worried about hourly costs getting out of control, it can make sense to negotiate a flat fee for a specific job, such as doing a prefilling review of your LLC paperwork. For example, the lawyer may review your articles of organization and operating agreement for \$300, or prepare special buy-sell, or buyout, provisions to control the transfer of LLC interests for \$500.
- **Retainer.** Some businesses can afford to pay relatively modest amounts, perhaps \$1,000

to \$2,000 a year, to keep a business lawyer "on retainer" for ongoing phone or in-person consultations or routine business matters during the year. Of course, your retainer won't cover a full-blown legal crisis, but it may take care of routine contract and other legal paperwork preparation and reviews.

- **Contingent fee based upon settlement amounts or winnings.** This type of fee typically occurs in personal injury, products liability, fraud, or employment discrimination disputes, where a lawsuit will likely be filed. The lawyer gets a percentage of the recovery (often 33% to 40%) if you win and nothing if you lose. (Of course, if your business is the defendant, not the plaintiff, expect to pay an hourly rate to defend the case or settle the dispute.)

Because most small business legal needs involve advice and help drafting paperwork, a contingency fee approach doesn't normally make sense. However, if you are seeking an award based upon a personal injury claim or lawsuit involving fraud, unfair competition, or the infringement of a patent or copyright, you may want to explore a contingency fee approach.

Especially at the beginning of your relationship, when you bring a big job to a lawyer, ask specifically about what it will cost. If you feel it's too much, don't hesitate to negotiate; perhaps you can do some of the routine work yourself, thus reducing the fee.

It's a good idea to get all fee arrangements in writing—especially those for good-sized jobs, such as reviewing your operating agreement. In several states, fee agreements between lawyers and clients must be in writing only if the expected fee is \$1,000 or more or is contingent on the outcome of a lawsuit. But whether required or not, it's always a good idea to get a written agreement.



TIP

Use nonlawyer professionals to cut down on legal costs. Often, nonlawyer professionals perform some tasks better and at less cost than lawyers. For example, look to management consultants for strategic business planning, real estate brokers or appraisers for valuation of properties, financial planners for investment advice, accountants for preparation of financial proposals, insurance agents for advice on insurance protection, independent paralegals for routine legal form drafting, and CPAs for the preparation of tax returns. Each of these matters is likely to have a legal aspect, and you may eventually want to consult your lawyer, but normally you can wait until you've gathered information on your own from these nonlawyer professionals.

Confront Problems Head-On

If you have any questions about a lawyer's bill or the quality of services, speak up. Buying legal help should be just like purchasing any other consumer service. If you are dissatisfied, seek a reduction in your bill or make it clear that the work needs to be redone properly (a more comprehensive lease, a better contract).

If the lawyer runs a decent business, he or she will promptly and positively deal with your concerns. If you don't get an acceptable response, find another lawyer pronto. If you switch lawyers, you are entitled to get your important documents back from the first lawyer.

Even if you fire your lawyer, you may still feel unjustly wronged. If you can't get satisfaction from the lawyer, write to the client grievance office of your state bar association (with a copy to the lawyer). Often, a phone call from this office to your lawyer will bring the desired results.

How to Do Your Own Legal Research

Law is information, not magic. If you can look up necessary information yourself, you need not purchase it from a lawyer—although if it involves important issues, you may wish to check your conclusions with a lawyer or use one as a sounding board for your intended course of action.

Much of the research necessary to understand your state's LLC law can be done without a lawyer by spending some time online or in a local law or business library browsing your state's LLC act. Even if you need to go to a lawyer for help preparing an LLC legal form or to discuss the legal implications of a proposed business transaction, you can give yourself a leg up by reading practice manuals prepared for lawyers and law students.

In doing legal research online or in a law library, there are a number of sources for legal rules, procedures, and issues that you may wish to examine. Here are a few:

- **State limited liability company statutes.** These state laws should be your primary focus

for finding the rules for organizing and operating your LLC. Appendix A explains how to find your state's LLC act online.

- **Other state laws, such as the Corporations, Partnerships, Securities, Commercial, Civil, Labor, and Revenue Codes.** These and other laws govern the operation of specific business transactions; the content, approval, and enforcement of commercial contracts; employment practices and procedures; employment tax requirements; and other aspects of doing business in your state. Depending on the type of business operations you engage in, you also may want to research statutes and regulations dealing with legal topics such as environmental law, products liability, real estate, copyrights, and so on.
- **Federal laws.** These include the tax laws and procedures found in the Internal Revenue Code; Treasury Regulations implementing these code sections; regulations dealing with advertising, warranties, and other consumer matters adopted by the Federal Trade Commission; and equal opportunity statutes such as Title VII of the Civil Rights Act administered by the Justice Department and Equal Employment Opportunity Commission.

- **Administrative rules and regulations (issued by federal and state administrative agencies charged with implementing statutes).** State and federal statutes are often supplemented with regulations that clarify specific statutes and contain rules for an agency to follow in implementing and enforcing them. For example, most states have enacted special administrative regulations under their securities statutes that provide exemptions for businesses registering the offer and sale of business interests to others within the state.
- **Case law.** This consists of decisions of federal and state courts interpreting statutes—and sometimes making law, known as “common law,” if the subject isn't covered by a statute. Annotated state legal codes contain not only the statutes, but also references to court cases interpreting and implementing specific provisions of the states' legal provisions.
- **Secondary sources.** Also important in researching business law are sources that provide background information on particular areas of law. One example is this book. Others are commonly found in the business, legal, or reference section of your local library or bookstore.



TIP

How to locate state statutes online. Go to Nolo's website at www.nolo.com. On the state laws page, at www.nolo.com/legal-research/state-law.html, you'll find links to the statutes of each state.

Nolo Resources

Below are a few titles published by Nolo that we believe offer valuable business information for LLCs and can be ordered or downloaded from Nolo's website (www.nolo.com).

- ***LLC or Corporation? How to Choose the Right Form for Your Business***, by Anthony Mancuso. This book explains in depth the legal and tax differences between an LLC and a corporation. It's filled with examples of how each type of entity works for new and growing businesses.
- **Nolo's online LLC formation service.** This helps you form your LLC directly on the Internet. Once you pick a package and complete a comprehensive interview online, Nolo will create a customized LLC operating agreement for your LLC and file your articles of organization with the state filing office (your LLC will come into existence the day the articles are filed).
- ***Your Limited Liability Company: An Operating Manual***, by Anthony Mancuso. This book with CD-ROM provides ready-to-use minutes forms for holding formal LLC meetings. It also contains forms and information for formally approving legal, tax, and other important business decisions that arise in the course of operating an LLC.
- ***Legal Guide for Starting & Running a Small Business***, by Fred S. Steingold. This book is an essential resource for every small business owner, whether just starting out or already established. Find out the basics about forming a business, negotiating a favorable lease, hiring and firing employees, writing contracts, and resolving business disputes.
- ***Business Buyout Agreements: Plan Now for Retirement, Death, Divorce or Owner Disagreements***, by Anthony Mancuso and Bethany K. Laurence. This book shows you how to adopt comprehensive buy-sell provisions to handle the purchase and sale of ownership interests in an LLC when an owner withdraws, dies, becomes disabled, or wishes to sell an interest to an outsider. Buy-sell agreements are included as tear-out forms and on disk.
- ***Tax Savvy for Small Business***, by Frederick W. Daily. This book gives business owners information about federal taxes and explains how to make the best tax decisions for business, maximize profits, and stay out of trouble with the IRS.
- ***The Employer's Legal Handbook***, by Fred S. Steingold. Here's a comprehensive resource that compiles all the basics of employment law in one place. It covers safe hiring practices, wages, hours, tips and commissions, employee benefits, taxes and liability, insurance, discrimination, sexual harassment, and termination.
- ***How to Write a Business Plan***, by Mike McKeever. If you're thinking of starting a business or raising money to expand an existing one, this book will show you how to write the business plan and loan package necessary to finance your business and make it work.
- ***Quicken Legal Business Pro***. This software program contains more than 140 business contracts, forms, letters, and checklists. It also contains five searchable Nolo business bestsellers:

Nolo Resources (cont'd)

Tax Savvy for Small Business, Legal Guide for Starting & Running a Small Business, The Manager's Legal Handbook, Negotiate the Best Lease for Your Business, and Marketing Without Advertising, as well as a downloadable version of *The Small Business Start-Up Kit*.

Small business owners often find that they need to learn more about intellectual property issues (patent, copyright, trademark, and trade secret law). Whether you're a do-it-yourselfer or simply wish to expand your knowledge of intellectual property law, here are some helpful resources:

- ***Patent, Copyright & Trademark: An Intellectual Property Desk Reference***, by Richard Stim. Written for anyone who needs to understand the terminology of intellectual property law, this book provides overviews and straightforward explanations of the protections offered by patent, copyright, trademark, and trade secret laws.
- ***Trademark: Legal Care for Your Business & Product Name***, by Stephen Elias and Richard Stim. This book shows small business owners how to choose, use, and protect the names and symbols that identify their services and products. It provides step-by-step instructions and all the official forms necessary to register a trademark with the U.S. Patent and Trademark Office.
- ***Patent It Yourself***, by David Pressman. This state-of-the-art guide is a must for any inventor who wants to get a patent—from the patent search to the actual application. Patent attorney and former patent examiner David Pressman covers use and licensing, successful marketing, and infringement.
- ***The Copyright Handbook: What Every Writer Needs to Know***, by Stephen Fishman. Provides fill-in-the-blanks forms and detailed instructions for protecting all types of written expression under U.S. and international copyright law. It also explains copyright infringement, fair use, works for hire, and transfers of copyright ownership.



How to Locate State LLC Offices and Laws Online

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The websites described below can provide you with information about the legal and tax rules for forming and operating an LLC (and other regulated business entities) in your state.

How to Locate State LLC Offices Online

Here's where to find your state business entity filing office and your state tax office.

State Business Entity Filing Website

This is the state office where you file articles (or a similar document) to form an LLC. In most states, you can also browse the business name database for free to check the availability of your proposed LLC name. In some states, you can reserve your LLC name online too. State filing office websites typically provide downloadable articles, name reservation request forms, and the latest formation and annual LLC fee information.

To find your state's business entity filing office website, go to www.statelocalgov.net. Choose your state, then "Secretary of State" (under "Statewide Offices"). From your state's secretary of state office, search the tabs and menus to find the filing or form information you need.

If you don't mind having to provide some information, you can find a direct link to your state's filing office at the website of the National Association of Secretaries of State (NASS) at www.nass.org. Register on the site (for free), then find your state under "Corporate Registration" (under "Business Services"); here you'll find links for your state's business entity filing office.

State Office Tax Website

This is the state office website where you can find state LLC (and individual) tax information and forms applicable in your state. Some states impose an annual LLC tax or fee.

To find your state's tax office website, go to the Federation of Tax Administrators website at www.taxadmin.org/fta/link/forms.html, then click on your state in the map to go to your state's tax agency website.

How to Locate Your State's LLC Act Online

Go to Nolo's State Laws Resources page at www.nolo.com/legal-research/state-law.html. Here you'll find links to the statutes of each state, indexed by topic headings. Most limited liability company acts are listed in a separate heading or in a subheading under a "Corporations and Associations or "Partnerships and Associations" heading.

If you can't easily find your state LLC act heading from the Nolo site, just type in the name of your state, followed by "Limited Liability Company Act" into your browser's search box—the search results should list one or more direct links to your state's LLC act online. ●

Tear-Out LLC Forms

IRS Form 8832, *Entity Classification Election*

LLC Reservation of Name Letter

Articles of Organization

LLC Articles Filing Letter

Operating Agreement for Member-Managed Limited Liability Company

Limited Liability Company Management Operating Agreement

Minutes of Meeting

Certification of Authority

Entity Classification Election

OMB No. 1545-1516

Type or Print	Name of eligible entity making election	Employer identification number
	Number, street, and room or suite no. If a P.O. box, see instructions.	
	City or town, state, and ZIP code. If a foreign address, enter city, province or state, postal code and country. Follow the country's practice for entering the postal code.	

► Check if: ☐ Address change ☐ Late classification relief sought under Revenue Procedure 2009-41

Part I Election Information

1 Type of election (see instructions):

- a** ☐ Initial classification by a newly-formed entity. Skip lines 2a and 2b and go to line 3.
b ☐ Change in current classification. Go to line 2a.

2a Has the eligible entity previously filed an entity election that had an effective date within the last 60 months?

- ☐ **Yes.** Go to line 2b.
☐ **No.** Skip line 2b and go to line 3.

2b Was the eligible entity's prior election an initial classification election by a newly formed entity that was effective on the date of formation?

- ☐ **Yes.** Go to line 3.
☐ **No.** Stop here. You generally are not currently eligible to make the election (see instructions).

3 Does the eligible entity have more than one owner?

- ☐ **Yes.** You can elect to be classified as a partnership or an association taxable as a corporation. Skip line 4 and go to line 5.
☐ **No.** You can elect to be classified as an association taxable as a corporation or to be disregarded as a separate entity. Go to line 4.

4 If the eligible entity has only one owner, provide the following information:

- a** Name of owner ► _____
b Identifying number of owner ► _____

5 If the eligible entity is owned by one or more affiliated corporations that file a consolidated return, provide the name and employer identification number of the parent corporation:

- a** Name of parent corporation ► _____
b Employer identification number ► _____

Part I Election Information (Continued)6 **Type of entity** (see instructions):

- a ☐ A domestic eligible entity electing to be classified as an association taxable as a corporation.
- b ☐ A domestic eligible entity electing to be classified as a partnership.
- c ☐ A domestic eligible entity with a single owner electing to be disregarded as a separate entity.
- d ☐ A foreign eligible entity electing to be classified as an association taxable as a corporation.
- e ☐ A foreign eligible entity electing to be classified as a partnership.
- f ☐ A foreign eligible entity with a single owner electing to be disregarded as a separate entity.

7 If the eligible entity is created or organized in a foreign jurisdiction, provide the foreign country of organization ►

8 Election is to be effective beginning (month, day, year) (see instructions) ► _____

9 Name and title of contact person whom the IRS may call for more information

10 Contact person's telephone number

Consent Statement and Signature(s) (see instructions)

Under penalties of perjury, I (we) declare that I (we) consent to the election of the above-named entity to be classified as indicated above, and that I (we) have examined this election and consent statement, and to the best of my (our) knowledge and belief, this election and consent statement are true, correct, and complete. If I am an officer, manager, or member signing for the entity, I further declare under penalties of perjury that I am authorized to make the election on its behalf.

[illegible]

11 Provide the explanation as to why the entity classification election was not filed on time (see instructions).

Under penalties of perjury, I (we) declare that I (we) have examined this election, including accompanying documents, and, to the best of my (our) knowledge and belief, the election contains all the relevant facts relating to the election, and such facts are true, correct, and complete. I (we) further declare that I (we) have personal knowledge of the facts and circumstances related to the election. I (we) further declare that the elements required for relief in Section 4.01 of Revenue Procedure 2009-41 have been satisfied.

[illegible]

General Instructions

Section references are to the Internal Revenue Code unless otherwise noted.

What Is New:

A checkbox was added to allow for the late election under Rev. Proc. 2009-41, 2009-39 I.R.B. 439.

Also, foreign entities that meet the requirements of Rev. Proc. 2010-32, 2010-36 I.R.B. 320 and that elect to be classified as a partnership rather than a disregarded entity or a disregarded entity rather than a partnership will be classified as the appropriate flow through entity depending on its actual number of owners instead of an association taxable as a corporation.

Purpose of Form

An eligible entity uses Form 8832 to elect how it will be classified for federal tax purposes, as a corporation, a partnership, or an entity disregarded as separate from its owner. An eligible entity is classified for federal tax purposes under the default rules described below unless it files Form 8832 or Form 2553, Election by a Small Business Corporation, to elect a classification or change its current classification. See Who Must File below.

The IRS will use the information entered on this form to establish the entity's filing and reporting requirements for federal tax purposes.



A new eligible entity should not file Form 8832 if it will be using its default classification (see Default Rules below).

Eligible entity. An eligible entity is a business entity that is not included in items 1, or 3 through 9, under the definition of **corporation** provided under **Definitions**. Eligible entities include limited liability companies (LLCs) and partnerships.

Generally, corporations are not eligible entities. However, the following types of corporations are treated as eligible entities:

1. An eligible entity that previously elected to be an association taxable as a corporation by filing Form 8832. An entity that elects to be classified as a corporation by filing Form 8832 can make another election to change its classification (see the *60-month limitation rule* discussed below in the instructions for lines 2a and 2b).

2. A foreign eligible entity that became an association taxable as a corporation under the foreign default rule described below.

Default Rules

Existing entity default rule. Certain domestic and foreign entities that were in existence before January 1, 1997, and have an established federal tax classification generally do not need to make an election to continue that classification. If an existing entity decides to change its classification, it may do so subject to the 60-month limitation rule. See the instructions for lines 2a and 2b. See Regulations sections 301.7701-3(b)(3) and 301.7701-3(h)(2) for more details.

Domestic default rule. Unless an election is made on Form 8832, a domestic eligible entity is:

1. A partnership if it has two or more members.
2. Disregarded as an entity separate from its owner if it has a single owner.

A change in the number of members of an eligible entity classified as an **association** (defined below) does not affect the entity's classification. However, an eligible entity classified as a partnership will become a disregarded entity when the entity's membership is reduced to one member and a disregarded entity will be classified as a partnership when the entity has more than one member.

Foreign default rule. Unless an election is made on Form 8832, a foreign eligible entity is:

1. A partnership if it has two or more members and at least one member does not have limited liability.
2. An association taxable as a corporation if all members have limited liability.
3. Disregarded as an entity separate from its owner if it has a single owner that does not have limited liability.

However, if a qualified foreign entity (as defined in section 3.02 of Rev. Proc. 2010-32) files a valid election to be classified as a partnership based on the reasonable assumption that it had two or more owners as of the effective date of the election, and the qualified entity is later determined to have a single owner, the IRS will deem the election to be an election to be classified as a disregarded entity provided:

1. The qualified entity's owner and purported owners file amended returns that are consistent with the treatment of the entity as a disregarded entity;
2. The amended returns are filed before the close of the period of limitations on assessments under section 6501(a) for the relevant taxable year; and
3. The corrected Form 8832 is filed and attached to the amended tax return. Corrected Form 8832 must include across the top the statement "FILED PURSUANT TO REVENUE PROCEDURE 2010-32;"

Also, if the qualified foreign entity (as defined in section 3.02 of Rev. Proc. 2010-32) files a valid election to be classified as a disregarded entity based on the reasonable assumption that it had a single owner as of the effective date of the election, and the qualified entity is later determined to have two or more owners, the IRS will deem the election to be an election to be classified as a partnership provided:

1. The qualified entity files information returns and the actual owners file original or amended returns consistent with the treatment of the entity as a partnership;
2. The amended returns are filed before the close of the period of limitations on assessments under section 6501(a) for the relevant taxable year; and
3. The corrected Form 8832 is filed and attached to the amended tax returns. Corrected Form 8832 must include across the

top the statement "FILED PURSUANT TO REVENUE PROCEDURE 2010-32"; see Rev. Proc. 2010-32, 2010-36 I.R.B. 320 for details.

Definitions

Association. For purposes of this form, an association is an eligible entity taxable as a corporation by election or, for foreign eligible entities, under the default rules (see Regulations section 301.7701-3).

Business entity. A business entity is any entity recognized for federal tax purposes that is not properly classified as a trust under Regulations section 301.7701-4 or otherwise subject to special treatment under the Code regarding the entity's classification. See Regulations section 301.7701-2(a).

Corporation. For federal tax purposes, a corporation is any of the following:

1. A business entity organized under a federal or state statute, or under a statute of a federally recognized Indian tribe, if the statute describes or refers to the entity as incorporated or as a corporation, body corporate, or body politic.
2. An association (as determined under Regulations section 301.7701-3).
3. A business entity organized under a state statute, if the statute describes or refers to the entity as a joint-stock company or joint-stock association.
4. An insurance company.
5. A state-chartered business entity conducting banking activities, if any of its deposits are insured under the Federal Deposit Insurance Act, as amended, 12 U.S.C. 1811 et seq., or a similar federal statute.
6. A business entity wholly owned by a state or any political subdivision thereof, or a business entity wholly owned by a foreign government or any other entity described in Regulations section 1.892-2T.
7. A business entity that is taxable as a corporation under a provision of the Code other than section 7701(a)(3).
8. A foreign business entity listed on page 7. See Regulations section 301.7701-2(b)(8) for any exceptions and inclusions to items on this list and for any revisions made to this list since these instructions were printed.
9. An entity created or organized under the laws of more than one jurisdiction (business entities with multiple charters) if the entity is treated as a corporation with respect to any one of the jurisdictions. See Regulations section 301.7701-2(b)(9) for examples.

Disregarded entity. A disregarded entity is an eligible entity that is treated as an entity not separate from its single owner for income tax purposes. A "disregarded entity" is treated as separate from its owner for:

- Employment tax purposes, effective for wages paid on or after January 1, 2009; and
- Excise taxes reported on Forms 720, 730, 2290, 11-C, or 8849, effective for excise taxes reported and paid after December 31, 2007.

See the employment tax and excise tax return instructions for more information.

Limited liability. A member of a foreign eligible entity has limited liability if the member has no personal liability for any debts of or claims against the entity by reason of being a member. This determination is based solely on the statute or law under which the entity is organized (and, if relevant, the entity's organizational documents). A member has personal liability if the creditors of the entity may seek satisfaction of all or any part of the debts or claims against the entity from the member as such. A member has personal liability even if the member makes an agreement under which another person (whether or not a member of the entity) assumes that liability or agrees to indemnify that member for that liability.

Partnership. A partnership is a business entity that has at least two members and is not a corporation as defined above under *Corporation*.

Who Must File

File this form for an eligible entity that is one of the following:

- A domestic entity electing to be classified as an association taxable as a corporation.
- A domestic entity electing to change its current classification (even if it is currently classified under the default rule).
- A foreign entity that has more than one owner, all owners having limited liability, electing to be classified as a partnership.
- A foreign entity that has at least one owner that does not have limited liability, electing to be classified as an association taxable as a corporation.
- A foreign entity with a single owner having limited liability, electing to be an entity disregarded as an entity separate from its owner.
- A foreign entity electing to change its current classification (even if it is currently classified under the default rule).

Do not file this form for an eligible entity that is:

- Tax-exempt under section 501(a);
- A real estate investment trust (REIT), as defined in section 856; or
- Electing to be classified as an S corporation. An eligible entity that timely files Form 2553 to elect classification as an S corporation and meets all other requirements to qualify as an S corporation is deemed to have made an election under Regulations section 301.7701-3(c)(v) to be classified as an association taxable as a corporation.

All three of these entities are deemed to have made an election to be classified as an association.

Effect of Election

The federal tax treatment of elective changes in classification as described in Regulations section 301.7701-3(g)(1) is summarized as follows:

- If an eligible entity classified as a partnership elects to be classified as an association, it is deemed that the partnership contributes all of its assets and liabilities to the association in exchange for stock in the association, and immediately thereafter, the partnership liquidates by distributing the stock of the association to its partners.
 - If an eligible entity classified as an association elects to be classified as a partnership, it is deemed that the association distributes all of its assets and liabilities to its shareholders in liquidation of the association, and immediately thereafter, the shareholders contribute all of the distributed assets and liabilities to a newly formed partnership.
 - If an eligible entity classified as an entity separate from its owner, it is deemed that the association distributes all of its assets and liabilities to its single owner in liquidation of the association.
 - If an eligible entity that is disregarded as an entity separate from its owner elects to be classified as an association, the owner of the eligible entity is deemed to have contributed all of the assets and liabilities of the entity to the association in exchange for the stock of the association.
- Note.** For information on the federal tax consequences of elective changes in classification, see Regulations section 301.7701-3(g).

When To File

Generally, an election specifying an eligible entity's classification cannot take effect more than 75 days prior to the date the election is filed, nor can it take effect later than 12 months after the date the election is filed. An eligible entity may be eligible for late election relief in certain circumstances. For more information, see *Late Election Relief*, later.

Where To File

File Form 8832 with the Internal Revenue Service Center for your state listed below.

In addition, attach a copy of Form 8832 to the entity's federal tax or information return for the tax year of the election. If the entity is not required to file a return for that year, a copy of its Form 8832 must be attached to the federal tax returns of all direct or indirect owners of the entity for the tax year of the owner that includes the date on which the election took effect. An indirect owner of the electing entity does not have to attach a copy of the Form 8832 to its tax return if an entity in which it has an interest is already filing a copy of the Form 8832 with its return. Failure to attach a copy of Form 8832 will not invalidate an otherwise valid election, but penalties may be assessed against persons who are required to, but do not, attach Form 8832.

Each member of the entity is required to file the member's return consistent with the entity election. Penalties apply to returns filed inconsistent with the entity's election.

If the entity's principal business, office, or agency is located in:

Use the following Internal Revenue Service Center address:

Connecticut, Delaware, District of Columbia, Illinois, Indiana, Kentucky, Maine, Maryland, Massachusetts, Michigan, New Hampshire, New Jersey, New York, North Carolina, Ohio, Pennsylvania, Rhode Island, South Carolina, Vermont, Virginia, West Virginia, Wisconsin

Cincinnati, OH 45999

If the entity's principal business, office, or agency is located in:

Use the following Internal Revenue Service Center address:

Alabama, Alaska, Arizona, Arkansas, California, Colorado, Florida, Georgia, Hawaii, Idaho, Iowa, Kansas, Louisiana, Minnesota, Mississippi, Missouri, Montana, Nebraska, Nevada, New Mexico, North Dakota, Oklahoma, Oregon, South Dakota, Tennessee, Texas, Utah, Washington, Wyoming

Ogden, UT 84201

A foreign country or U.S. possession

Ogden, UT
84201-0023

Note. Also attach a copy to the entity's federal income tax return for the tax year of the election.

Acceptance or Nonacceptance of Election

The service center will notify the eligible entity at the address listed on Form 8832 if its election is accepted or not accepted. The entity should generally receive a determination on its election within 60 days after it has filed Form 8832.

Care should be exercised to ensure that the IRS receives the election. If the entity is not notified of acceptance or nonacceptance of its election within 60 days of the date of filing, take follow-up action by calling 1-800-829-0115, or by sending a letter to the service center to inquire about its status. Send any such letter by certified or registered mail via the U.S. Postal Service, or equivalent type of delivery by a designated private delivery service (see Notice 2004-83, 2004-52 I.R.B. 1030 (or its successor)).

If the IRS questions whether Form 8832 was filed, an acceptable proof of filing is:

- A certified or registered mail receipt (timely postmarked) from the U.S. Postal Service, or its equivalent from a designated private delivery service;
- Form 8832 with an accepted stamp;
- Form 8832 with a stamped IRS received date; or
- An IRS letter stating that Form 8832 has been accepted.

Specific Instructions

Name. Enter the name of the eligible entity electing to be classified.

Employer identification number (EIN). Show the EIN of the eligible entity electing to be classified.



Do not put "Applied For" on this line.

Note. Any entity that has an EIN will retain that EIN even if its federal tax classification changes under Regulations section 301.7701-3.

If a disregarded entity's classification changes so that it becomes recognized as a partnership or association for federal tax purposes, and that entity had an EIN, then the entity must continue to use that EIN. If the entity did not already have its own EIN, then the entity must apply for an EIN and not use the identifying number of the single owner.

A foreign entity that makes an election under Regulations section 301.7701-3(c) and (d) must also use its own taxpayer identifying number. See sections 6721 through 6724 for penalties that may apply for failure to supply taxpayer identifying numbers.

If the entity electing to be classified using Form 8832 does not have an EIN, it must apply for one on Form SS-4, Application for Employer Identification Number. The entity must have received an EIN by the time Form 8832 is filed in order for the form to be processed. An election will not be accepted if the eligible entity does not provide an EIN.



Do not apply for a new EIN for an existing entity that is changing its classification if the entity already has an EIN.

Address. Enter the address of the entity electing a classification. All correspondence regarding the acceptance or nonacceptance of the election will be sent to this address. Include the suite, room, or other unit number after the street address. If the Post Office does not deliver mail to the street address and the entity has a P.O. box, show the box number instead of the street address. If the electing entity receives its mail in care of a third party (such as an accountant or an attorney), enter on the street address line "C/O" followed by the third party's name and street address or P.O. box.

Address change. If the eligible entity has changed its address since filing Form SS-4 or the entity's most recently-filed return (including a change to an "in care of" address), check the box for an address change.

Note. If a change of address occurs after the later of the filing of Form SS-4 or the most recently-filed return, use Form 8822, Change of Address, to notify the IRS of the new address. A new address shown on Form 8832 will not update the entity's address of record with the IRS.

Late-classification relief sought under Revenue Procedure 2009-41. Check the box if the entity is seeking relief under Rev. Proc. 2009-41, 2009-39 I.R.B. 439, for a late classification election. For more information, see *Late Election Relief*, later.

Part I. Election Information

Complete Part I whether or not the entity is seeking late-election relief under Rev. Proc. 2009-41.

Line 1. Check box 1a if the entity is choosing a classification for the first time (i.e., the entity does not want to be classified under the applicable default classification). Do not file this form if the entity wants to be classified under the default rules.

Check box 1b if the entity is changing its current classification.

Lines 2a and 2b. 60-month limitation rule. Once an eligible entity makes an election to change its classification, the entity generally cannot change its classification by election again during the 60 months after the effective date of the election. However, the IRS may (by private letter ruling) permit the entity to change its classification by election within the 60-month period if more than 50% of the ownership interests in the entity, as of the effective date of the election, are owned by persons that did not own any interests in the entity on the effective date or the filing date of the entity's prior election.

Note. The 60-month limitation does not apply if the previous election was made by a newly formed eligible entity and was effective on the date of formation.

Line 4. If an eligible entity has only one owner, provide the name of its owner on line 4a and the owner's identifying number (social security number, or individual taxpayer identification number, or EIN) on line 4b. If the electing eligible entity is owned by an entity that is a disregarded entity or by an entity that is a member of a series of tiered disregarded entities, identify the first entity (the entity closest to the electing eligible entity) that is not a disregarded entity. For example, if the electing eligible entity is owned by disregarded entity A, which is owned by another disregarded entity B, and disregarded entity B is owned by partnership C, provide the name and EIN of partnership C as the owner of the electing eligible entity. If the owner is a foreign person or entity and does not have a U.S. identifying number, enter "none" on line 4b.

Line 5. If the eligible entity is owned by one or more members of an affiliated group of corporations that file a consolidated return, provide the name and EIN of the parent corporation.

Line 6. Check the appropriate box if you are changing a current classification (no matter how achieved), or are electing out of a default classification. Do not file this form if you fall within a default classification that is the desired classification for the new entity.

Line 7. If the entity making the election is created or organized in a foreign jurisdiction, enter the name of the foreign country in which it is organized. This information must be provided even if the entity is also organized under domestic law.

Line 8. Generally, the election will take effect on the date you enter on line 8 of this form, or on the date filed if no date is entered on line 8. An election specifying an entity's classification for federal tax purposes can take effect no more than 75 days prior to the date the election is filed, nor can it take effect later than 12 months after the date on which the election is filed. If line 8 shows a date more than 75 days prior to the date on which the election is filed, the election will default to 75 days before the date it is filed. If line 8 shows an effective date more than 12 months from the filing date, the election will take effect 12 months after the date the election is filed.

Consent statement and signature(s). Form 8832 must be signed by:

1. Each member of the electing entity who is an owner at the time the election is filed; or
2. Any officer, manager, or member of the electing entity who is authorized (under local law or the organizational documents) to make the election. The elector represents to having such authorization under penalties of perjury.

If an election is to be effective for any period prior to the time it is filed, each person who was an owner between the date the election is to be effective and the date the election is filed, must sign.

If you need a continuation sheet or use a separate consent statement, attach it to Form 8832. The separate consent statement must contain the same information as shown on Form 8832.

Note. Do not sign the copy that is attached to your tax return.

Part II. Late Election Relief

Complete Part II only if the entity is requesting late election relief under Rev. Proc. 2009-41.

An eligible entity may be eligible for late election relief under Rev. Proc. 2009-41, 2009-39 I.R.B. 439, if **each** of the following requirements is met.

1. The entity failed to obtain its requested classification as of the date of its formation (or upon the entity's classification becoming relevant) or failed to obtain its requested change in classification solely because Form 8832 was not filed timely.

2. Either:

a. The entity has not filed a federal tax or information return for the first year in which the election was intended because the due date has not passed for that year's federal tax or information return; or

b. The entity has timely filed all required federal tax returns and information returns (or if not timely, within 6 months after its due date, excluding extensions) consistent with its requested classification for all of the years the entity intended the requested election to be effective and no inconsistent tax or information returns have been filed by or with respect to the entity during any of the tax years. If the eligible entity is not required to file a federal tax return or information return, each affected person who is required to file a federal tax return or information return must have timely filed all such returns (or if not

timely, within 6 months after its due date, excluding extensions) consistent with the entity's requested classification for all of the years the entity intended the requested election to be effective and no inconsistent tax or information returns have been filed during any of the tax years.

3. The entity has reasonable cause for its failure to timely make the entity classification election.

4. Three years and 75 days from the requested effective date of the eligible entity's classification election have not passed.

Affected person. An affected person is either:

- with respect to the effective date of the eligible entity's classification election, a person who would have been required to attach a copy of the Form 8832 for the eligible entity to its federal tax or information return for the tax year of the person which includes that date; or
- with respect to any subsequent date after the entity's requested effective date of the classification election, a person who would have been required to attach a copy of the Form 8832 for the eligible entity to its federal tax or information return for the person's taxable year that includes that subsequent date had the election first become effective on that subsequent date.

For details on the requirement to attach a copy of Form 8832, see Rev. Proc. 2009-41 and the instructions under *Where To File*.

To obtain relief, file Form 8832 with the applicable IRS service center listed in *Where To File*, earlier, within 3 years and 75 days from the requested effective date of the eligible entity's classification election.

If Rev. Proc. 2009-41 does not apply, an entity may seek relief for a late entity election by requesting a private letter ruling and paying a user fee in accordance with Rev. Proc. 2011-1, 2011-1 I.R.B. 1 (or its successor).

Line 11. Explain the reason for the failure to file a timely entity classification election.

Signatures. Part II of Form 8832 must be signed by an authorized representative of the eligible entity and each affected person. See *Affected Persons*, earlier. The individual or individuals who sign the declaration must have personal knowledge of the facts and circumstances related to the election.

Foreign Entities Classified as Corporations for Federal Tax Purposes:

American Samoa—Corporation
Argentina—Sociedad Anonima
Australia—Public Limited Company
Austria—Aktiengesellschaft
Barbados—Limited Company
Belgium—Societe Anonyme
Belize—Public Limited Company
Bolivia—Sociedad Anonima
Brazil—Sociedade Anonima
Bulgaria—Aktционерно Дружество
Canada—Corporation and Company
Chile—Sociedad Anonima
People's Republic of China—Gufen Youxian Gongsi

Republic of China (Taiwan)—Ku-fen Yu-hsien Kung-szu
Colombia—Sociedad Anonima
Costa Rica—Sociedad Anonima
Cyprus—Public Limited Company
Czech Republic—Akciova Spolecnost
Denmark—Aktieselskab
Ecuador—Sociedad Anonima or Compania Anonima
Egypt—Sharikat Al-Mossamahah
El Salvador—Sociedad Anonima
Estonia—Aktiselselts
European Economic Area/European Union—Societas Europaea
Finland—Julkinen Osakeyhtio/Publikt Aktiebolag
France—Societe Anonyme
Germany—Aktiengesellschaft
Greece—Anonymos Etairia
Guam—Corporation
Guatemala—Sociedad Anonima
Guyana—Public Limited Company
Honduras—Sociedad Anonima
Hong Kong—Public Limited Company
Hungary—Reszvenytarsasag
Iceland—Hlutafelag
India—Public Limited Company
Indonesia—Perseroan Terbuka
Ireland—Public Limited Company
Israel—Public Limited Company
Italy—Societa per Azioni
Jamaica—Public Limited Company
Japan—Kabushiki Kaisha
Kazakhstan—Ashyk Aktzionerlik Kogham
Republic of Korea—Chusik Hoesa
Latvia—Akciju Sabiedriba
Liberia—Corporation
Liechtenstein—Aktiengesellschaft
Lithuania—Akcine Bendroves
Luxembourg—Societe Anonyme
Malaysia—Berhad
Malta—Public Limited Company
Mexico—Sociedad Anonima
Morocco—Societe Anonyme
Netherlands—Naamloze Vennootschap
New Zealand—Limited Company
Nicaragua—Compania Anonima
Nigeria—Public Limited Company
Northern Mariana Islands—Corporation
Norway—Allment Aksjeselskap
Pakistan—Public Limited Company
Panama—Sociedad Anonima
Paraguay—Sociedad Anonima
Peru—Sociedad Anonima
Philippines—Stock Corporation
Poland—Spolka Akcyjna
Portugal—Sociedade Anonima
Puerto Rico—Corporation

Romania—Societe pe Actiuni
Russia—Otkrytoye Aktsionernoy Obshchestvo
Saudi Arabia—Sharikat Al-Mossamahah
Singapore—Public Limited Company
Slovak Republic—Akciova Spolocnost
Slovenia—Delniska Druzba
South Africa—Public Limited Company
Spain—Sociedad Anonima
Surinam—Naamloze Vennootschap
Sweden—Publika Aktiebolag
Switzerland—Aktiengesellschaft
Thailand—Borisat Chamkad (Mahachon)
Trinidad and Tobago—Limited Company
Tunisia—Societe Anonyme
Turkey—Anonim Sirket
Ukraine—Aktzionerne Tovaristvo Vidkritogo Tipu
United Kingdom—Public Limited Company
United States Virgin Islands—Corporation
Uruguay—Sociedad Anonima
Venezuela—Sociedad Anonima or Compania Anonima



See Regulations section 301.7701-2(b)(8) for any exceptions and inclusions to items on this list and for any revisions made to this list since these instructions were printed.

Paperwork Reduction Act Notice

We ask for the information on this form to carry out the Internal Revenue laws of the United States. You are required to give us the information. We need it to ensure that you are complying with these laws and to allow us to figure and collect the right amount of tax.

You are not required to provide the information requested on a form that is subject to the Paperwork Reduction Act unless the form displays a valid OMB control number. Books or records relating to a form or its instructions must be retained as long as their contents may become material in the administration of any Internal Revenue law. Generally, tax returns and return information are confidential, as required by section 6103.

The time needed to complete and file this form will vary depending on individual circumstances. The estimated average time is:

Recordkeeping 1 hr., 49 min.

Learning about the law or the form 2 hr., 25 min.

Preparing and sending the form to the IRS 23 min.

If you have comments concerning the accuracy of these time estimates or suggestions for making this form simpler, we would be happy to hear from you. You can write to the Internal Revenue Service, Tax Products Coordinating Committee, SE:W: CAR:MP:T:T:SP, 1111 Constitution Ave. NW, IR-6406, Washington, DC 20224. Do not send the form to this address. Instead, see *Where To File* above.

LLC Reservation of Name Letter

LLC Filings Office:

Please reserve the following proposed limited liability company name for my use for the allowable period specified under state law:

_____.

☐ If the above name is not available, please reserve the first available name from the following list of alternative names:

Second choice: _____

Third choice: _____

I enclose a check in payment of the reservation fee. Please send a certificate, receipt for payment, or other acknowledgment or approval of my reservation request to me at my address shown below.

Thank you for your assistance,

Enclosure: check reservation fee; stamped, self-addressed envelope

Articles of Organization

The undersigned natural person(s), of the age of eighteen years or more, acting as organizer(s) of a limited liability company under the State of _____ Limited Liability Company Act, adopt(s) the following articles of organization for such limited liability company.

Article 1. Name of Limited Liability Company. The name of this limited liability company is

_____.

Article 2. Registered Office and Registered Agent. The initial registered office of this limited liability company and the name of its initial registered agent at this address are:

_____.

Article 3. Statement of Purposes. The purposes for which this limited liability company is organized are:

_____.

Article 4. Management and Names and Addresses of Initial _____. The management of this limited liability company is reserved to the _____. The names and addresses of its initial _____ are:

_____.

Article 5. Principal Place of Business of the Limited Liability Company. The principal place of business of the limited liability company shall be: _____

_____.

Article 6. Period of Duration of the Limited Liability Company. The period of duration of the limited liability company shall be: _____
_____.

In witness whereof, the undersigned organizer(s) of this limited liability company has (have) signed these articles of organization on the date indicated.

Date: _____

Signature(s): _____

_____ Organizer	_____ Typed or Printed Name
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_____ Organizer	_____ Typed or Printed Name
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_____ Organizer	_____ Typed or Printed Name
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_____ Organizer	_____ Typed or Printed Name
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_____ Organizer	_____ Typed or Printed Name
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_____ Organizer	_____ Typed or Printed Name
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LLC Articles Filing Letter

LLC Filings Office:

I enclose an original and _____ copies of the proposed articles of organization of _____, a proposed domestic limited liability company.

Please file the articles of organization and return a file-stamped copy of the original articles or other receipt, acknowledgment, or proof of filing to me at the address below.

A check/money order in the amount of \$_____, made payable to your office, for total filing and processing fees is enclosed.

☐ The above LLC name was reserved for my use _____, issued on _____.

Sincerely,

_____, Organizer

Enclosures: articles of organization; check

Operating Agreement for Member-Managed Limited Liability Company

I. Preliminary Provisions

(1) **Effective Date:** This operating agreement of _____, effective _____, is adopted by the members whose signatures appear at the end of this agreement.

(2) **Formation:** This limited liability company (LLC) was formed by filing articles of organization, a certificate of formation, or a similar organizational document with the LLC filing office of the state of _____ on _____.

A copy of this organizational document has been placed in the LLC's records book.

(3) **Name:** The formal name of this LLC is as stated above. However, this LLC may do business under a different name by complying with the state's fictitious or assumed business name statutes and procedures.

(4) **Registered Office and Agent:** The registered office of this LLC and the registered agent at this address are as follows: _____.

The registered office and agent may be changed from time to time as the members may see fit, by filing a change of registered agent or office form with the state LLC filing office. It will not be necessary to amend this provision of the operating agreement if and when such a change is made.

(5) **Business Purposes:** The specific business purposes and activities contemplated by the founders of this LLC at the time of initial signing of this agreement consist of the following:

_____.

It is understood that the foregoing statement of purposes shall not serve as a limitation on the powers or abilities of this LLC, which shall be permitted to engage in any and all lawful business activities. If this LLC intends to engage in business activities outside the state of its formation that require the qualification of the LLC in other states, it shall obtain such qualification before engaging in such out-of-state activities.

(6) **Duration of LLC:** The duration of this LLC shall be _____.

Further, this LLC shall terminate when a proposal to dissolve the LLC is adopted by the membership of this LLC or when this LLC is otherwise terminated in accordance with law.

II. Membership Provisions

(1) **Nonliability of Members:** No member of this LLC shall be personally liable for the expenses, debts, obligations, or liabilities of the LLC, or for claims made against it.

(2) Reimbursement for Organizational Costs: Members shall be reimbursed by the LLC for organizational expenses paid by the members. The LLC shall be authorized to elect to deduct and amortize organizational expenses and start-up expenditures as permitted by the Internal Revenue Code and as may be advised by the LLC's tax adviser.

(3) Management: This LLC shall be managed exclusively by all of its members.

(4) Members' Percentage Interests: A member's percentage interest in this LLC shall be computed as a fraction, the numerator of which is the total of a member's capital account and the denominator of which is the total of all capital accounts of all members. This fraction shall be expressed in this agreement as a percentage, which shall be called each member's "percentage interest" in this LLC.

(5) Membership Voting: Except as otherwise may be required by the articles of organization, certificate of formation, or a similar organizational document, by other provisions of this operating agreement, or under the laws of this state, each member shall vote on any matter submitted to the membership for approval in proportion to the member's percentage interest in this LLC. Further, unless defined otherwise for a particular provision of this operating agreement, the phrase "majority of members" means the vote of members whose combined votes equal more than 50% of the votes of all members in this LLC, and a majority of members, so defined, may approve any item of business brought before the membership for a vote unless a different vote is required under this operating agreement or state law.

(6) Compensation: Members shall not be paid as members of the LLC for performing any duties associated with such membership, including management of the LLC. Members may be paid, however, for any services rendered in any other capacity for the LLC, whether as officers, employees, independent contractors, or otherwise.

(7) Members' Meetings: The LLC shall not provide for regular members' meetings. However, any member may call a meeting by communicating his or her wish to schedule a meeting to all other members. Such notification may be in person or in writing, or by telephone, facsimile machine, or other form of electronic communication reasonably expected to be received by a member, and the other members shall then agree, either personally, in writing, or by telephone, facsimile machine, or other form of electronic communication to the member calling the meeting, to meet at a mutually acceptable time and place. Notice of the business to be transacted at the meeting need not be given to members by the member calling the meeting, and any business may be discussed and conducted at the meeting.

If all members cannot attend a meeting, it shall be postponed to a date and time when all members can attend, unless all members who do not attend have agreed in writing to the holding of the meeting without them. If a meeting is postponed, and the postponed meeting cannot be held either because all members do not attend the postponed meeting or the nonattending members have not signed a written consent to allow the postponed meeting to be held without them, a second postponed meeting may be held at a date and time announced at the first postponed meeting. The date and time of the second postponed meeting shall also be communicated to any members not attending the first postponed meeting. The second postponed meeting may be held without the attendance of all members as long as a majority of the percentage interests of the membership of this LLC is in attendance at the second postponed meeting. Written notice of the decisions or approvals made at this second postponed meeting shall be mailed or delivered to each non-attending member promptly after the holding of the second postponed meeting.

Written minutes of the discussions and proposals presented at a members' meeting, and the votes taken and matters approved at such meeting, shall be taken by one of the members or a person designated at the meeting. A copy of the minutes of the meeting shall be placed in the LLC's records book after the meeting.

(8) Membership Certificates: This LLC shall be authorized to obtain and issue certificates representing or certifying membership interests in this LLC. Each certificate shall show the name of the LLC and the name of the member, and state that the person named is a member of the LLC and is entitled to all the rights granted members of the LLC under the articles of organization, certificate of formation, or a similar organizational document; this operating agreement; and provisions of law. Each membership certificate shall be consecutively numbered and signed by one or more officers of this LLC. The certificates shall include any additional information considered appropriate for inclusion by the members on membership certificates.

In addition to the above information, all membership certificates shall bear a prominent legend on their face or reverse side stating, summarizing, or referring to any transfer restrictions that apply to memberships in this LLC under the articles of organization, certificate of formation, or a similar organizational document, and/or this operating agreement as well as the address where a member may obtain a copy of these restrictions upon request from this LLC.

The records book of this LLC shall contain a list of the names and addresses of all persons to whom certificates have been issued, show the date of issuance of each certificate, and record the date of all cancellations or transfers of membership certificates.

(9) Other Business by Members: Each member shall agree not to own an interest in, manage, or work for another business, enterprise, or endeavor, if such ownership or activities would compete with this LLC's business goals, mission, profitability, or productivity, or would diminish or impair the member's ability to provide maximum effort and performance in managing the business of this LLC.

III. Tax and Financial Provisions

(1) Tax Classification of LLC: The members of this LLC intend that this LLC be initially classified as a _____ for federal and, if applicable, state income tax purposes. It is understood that, subject to federal and state law requirements, all members may agree to change the tax treatment of this LLC by signing, or authorizing the signature of, IRS Form 8832, *Entity Classification Election*, and filing it with the IRS and, if applicable, the state tax department within the prescribed time limits.

(2) Tax Year and Accounting Method: The tax year of this LLC shall be _____. The LLC shall use the _____ method of accounting. Both the tax year and the accounting period of the LLC may be changed with the consent of all members if the LLC qualifies for such change, and may be effected by the filing of appropriate forms with the IRS and state tax authorities.

(3) Tax Matters Partner: If this LLC is required under Internal Revenue Code provisions or regulations, it shall designate from among its members a "tax matters partner" in accordance with Internal Revenue Code Section 6231(a)(7) and corresponding regulations, who will fulfill this role by being the spokesperson for the LLC in dealings with the IRS as required under the Internal Revenue Code and Regulations, and who will report to the members on the progress and outcome of these dealings.

(4) Annual Income Tax Returns and Reports: Within 60 days after the end of each tax year of the LLC, a copy of the LLC's state and federal income tax returns for the preceding tax year shall be mailed or otherwise provided to each member of the LLC, together with any additional information and forms necessary for each member to complete his or her individual state and federal income tax returns. If this LLC is classified as a partnership for income tax purposes, this additional information shall include a federal (and, if applicable, state) Schedule K-1 (Form 1065, *Partner's Share of Income, Deductions, Credits, etc.*) or equivalent income tax reporting form. This additional information shall also include a financial report, which shall include a balance sheet and profit and loss statement for the prior tax year of the LLC.

(5) Bank Accounts: The LLC shall designate one or more banks or other institutions for the deposit of the funds of the LLC, and shall establish savings, checking, investment, and other such accounts as are reasonable and necessary for its business and investments. One or more members of the LLC shall be designated with the consent of all members to deposit and withdraw funds of the LLC, and to direct the investment of funds from, into, and among such accounts. The funds of the LLC, however and wherever deposited or invested, shall not be commingled with the personal funds of any members of the LLC.

(6) Title to Assets: All personal and real property of this LLC shall be held in the name of the LLC, not in the names of individual members.

IV. Capital Provisions

(1) Capital Contributions by Members: Members shall make the following contributions of cash, property, or services as shown next to each member's name below. Unless otherwise noted, cash and property described below shall be paid or delivered to the LLC on or by _____. The fair market values of items of property or services as agreed between the LLC and the contributing member are also shown below. The percentage interest in the LLC that each member shall receive in return for his or her capital contribution is also indicated for each member.

Name	Contribution	Fair Market Value	Percentage Interest in LLC
_____	_____	\$ _____	_____
_____	_____	\$ _____	_____
_____	_____	\$ _____	_____
_____	_____	\$ _____	_____
_____	_____	\$ _____	_____
_____	_____	\$ _____	_____

(2) Additional Contributions by Members: The members may agree, from time to time by unanimous vote, to require the payment of additional capital contributions by the members, on or by a mutually agreeable date.

(3) Failure to Make Contributions: If a member fails to make a required capital contribution within the time agreed for a member's contribution, the remaining members may, by unanimous vote, agree to reschedule the time for payment of the capital contribution by the late-paying member, setting any additional repayment terms, such as a late payment penalty, rate of interest to be applied to the unpaid balance, or other monetary amount to be paid by the delinquent member, as the remaining members decide. Alternatively, the remaining members may, by unanimous vote, agree to cancel the membership of the delinquent member, provided any prior partial payments of capital made by the delinquent member are refunded by the LLC to the member promptly after the decision is made to terminate the membership of the delinquent member.

(4) No Interest on Capital Contributions: No interest shall be paid on funds or property contributed as capital to this LLC, or on funds reflected in the capital accounts of the members.

(5) Capital Account Bookkeeping: A capital account shall be set up and maintained on the books of the LLC for each member. It shall reflect each member's capital contribution to the LLC, increased by each member's share of profits in the LLC, decreased by each member's share of losses and expenses of the LLC, and adjusted as required in accordance with applicable provisions of the Internal Revenue Code and corresponding income tax regulations.

(6) Consent to Capital Contribution Withdrawals and Distributions: Members shall not be allowed to withdraw any part of their capital contributions or to receive distributions, whether in property or cash, except as otherwise allowed by this agreement and, in any case, only if such withdrawal is made with the written consent of all members.

(7) Allocations of Profits and Losses: No member shall be given priority or preference with respect to other members in obtaining a return of capital contributions, distributions, or allocations of the income, gains, losses, deductions, credits, or other items of the LLC. The profits and losses of the LLC, and all items of its income, gain, loss, deduction, and credit shall be allocated to members according to each member's percentage interest in this LLC.

(8) Allocation and Distribution of Cash to Members: Cash from LLC business operations, as well as cash from a sale or other disposition of LLC capital assets, may be distributed from time to time to members in accordance with each member's percentage interest in the LLC, as may be decided by _____ of the members.

(9) Allocation of Noncash Distributions: If proceeds consist of property other than cash, the members shall decide the value of the property and allocate such value among the members in accordance with each member's percentage interest in the LLC. If such noncash proceeds are later reduced to cash, such cash may be distributed among the members as otherwise provided in this agreement.

(10) Allocation and Distribution of Liquidation Proceeds: Regardless of any other provision in this agreement, if there is a distribution in liquidation of this LLC, or when any member's interest is liquidated, all items of income and loss shall be allocated to the members' capital accounts, and all appropriate credits and deductions shall then be made to these capital accounts before any final distribution is made. A final distribution shall be made to members only to the extent of, and in proportion to, any positive balance in each member's capital account.

V. Membership Withdrawal and Transfer Provisions

(1) **Withdrawal of Members:** A member may withdraw from this LLC by giving written notice to all other members at least _____ days before the date the withdrawal is to be effective.

(2) **Restrictions on the Transfer of Membership:** A member shall not transfer his or her membership in the LLC unless all nontransferring members in the LLC first agree to approve the admission of the transferee into this LLC. Further, no member may encumber a part or all of his or her membership in the LLC by mortgage, pledge, granting of a security interest, lien, or otherwise, unless the encumbrance has first been approved in writing by all other members of the LLC.

Notwithstanding the above provision, any member shall be allowed to assign an economic interest in his or her membership to another person without the approval of the other members. Such an assignment shall not include a transfer of the member's voting or management rights in this LLC, and the assignee shall not become a member of the LLC.

VI. Dissolution Provisions

(1) **Events That Trigger Dissolution of the LLC:** The following events shall trigger a dissolution of the LLC, except as provided:

- (a) the death, incapacity, bankruptcy, retirement, resignation, or expulsion of a member, except that within _____ of the happening of any of these events, all remaining members of the LLC may vote to continue the legal existence of the LLC, in which case the LLC shall not dissolve
- (b) the expiration of the term of existence of the LLC if such term is specified in the articles of organization, certificate of formation, or a similar organizational document, or this operating agreement
- (c) the written agreement of all members to dissolve the LLC
- (d) entry of a decree of dissolution of the LLC under state law.

VII. General Provisions

(1) **Officers:** The LLC may designate one or more officers, such as a president, vice president, secretary, and treasurer. Persons who fill these positions need not be members of the LLC. Such positions may be compensated or noncompensated according to the nature and extent of the services rendered for the LLC as a part of the duties of each office. Ministerial services only as a part of any officer position will normally not be compensated, such as the performance of officer duties specified in this agreement, but any officer may be reimbursed by the LLC for out-of-pocket expenses paid by the officer in carrying out the duties of his or her office.

(2) **Records:** The LLC shall keep at its principal business address a copy of all proceedings of membership meetings, as well as books of account of the LLC's financial transactions. A list of the names and addresses of the current membership of the LLC also shall be maintained at this address, with notations on any transfers of members' interests to nonmembers or persons being admitted into membership in the LLC.

Copies of the LLC's articles of organization, certificate of formation, or a similar organizational document; a signed copy of this operating agreement; and the LLC's tax returns for the preceding three tax years shall be kept at the principal business address of the LLC. A statement also shall be kept at this address containing any of the following information that is applicable to this LLC:

- the amount of cash or a description and value of property contributed or agreed to be contributed as capital to the LLC by each member
- a schedule showing when any additional capital contributions are to be made by members to this LLC
- a statement or schedule, if appropriate, showing the rights of members to receive distributions representing a return of part or all of members' capital contributions, and
- a description of, or date when, the legal existence of the LLC will terminate under provisions in the LLC's articles of organization, certificate of formation, or a similar organizational document, or this operating agreement.

If one or more of the above items is included or listed in this operating agreement, it will be sufficient to keep a copy of this agreement at the principal business address of the LLC without having to prepare and keep a separate record of such item or items at this address.

Any member may inspect any and all records maintained by the LLC upon reasonable notice to the LLC. Copying of the LLC's records by members is allowed, but copying costs shall be paid for by the requesting member.

(3) All Necessary Acts: The members and officers of this LLC are authorized to perform all acts necessary to perfect the organization of this LLC and to carry out its business operations expeditiously and efficiently. The secretary of the LLC, or other officers, or all members of the LLC, may certify to other businesses, financial institutions, and individuals as to the authority of one or more members or officers of this LLC to transact specific items of business on behalf of the LLC.

(4) Mediation and Arbitration of Disputes Among Members: In any dispute over the provisions of this operating agreement and in other disputes among the members, if the members cannot resolve the dispute to their mutual satisfaction, the matter shall be submitted to mediation. The terms and procedure for mediation shall be arranged by the parties to the dispute.

If good-faith mediation of a dispute proves impossible or if an agreed-upon mediation outcome cannot be obtained by the members who are parties to the dispute, the dispute may be submitted to arbitration in accordance with the rules of the American Arbitration Association. Any party may commence arbitration of the dispute by sending a written request for arbitration to all other parties to the dispute. The request shall state the nature of the dispute to be resolved by arbitration, and, if all parties to the dispute agree to arbitration, arbitration shall be commenced as soon as practical after such parties receive a copy of the written request.

All parties shall initially share the cost of arbitration, but the prevailing party or parties may be awarded attorney fees, costs, and other expenses of arbitration. All arbitration decisions shall be final, binding, and conclusive on all the parties to arbitration, and legal judgment may be entered based upon such decision in accordance with applicable law in any court having jurisdiction to do so.

(5) Entire Agreement: This operating agreement represents the entire agreement among the members of this LLC, and it shall not be amended, modified, or replaced except by a written instrument executed by all the parties to this agreement who are current members of this LLC as well as any and all additional parties who became members of this LLC after the adoption of this agreement. This agreement replaces and supersedes all prior written and oral agreements among any and all members of this LLC.

(6) Severability: If any provision of this agreement is determined by a court or arbitrator to be invalid, unenforceable, or otherwise ineffective, that provision shall be severed from the rest of this agreement, and the remaining provisions shall remain in effect and enforceable.

VIII. Signatures of Members and Spouses

(1) Execution of Agreement: In witness whereof, the members of this LLC sign and adopt this agreement as the operating agreement of this LLC.

Date: _____

Signature: _____

Printed Name: _____, Member

Date: _____

Signature: _____

Printed Name: _____, Member

Date: _____

Signature: _____

Printed Name: _____, Member

Date: _____

Signature: _____

Printed Name: _____, Member

Date: _____

Signature: _____

Printed Name: _____, Member

Date: _____

Signature: _____

Printed Name: _____, Member

(2) Consent of Spouses: The undersigned are spouses of the members of this LLC who have signed this operating agreement in the preceding provision. These spouses have read this agreement and agree to be bound by its terms in any matter in which they have a financial interest, including restrictions on the transfer of memberships and the terms under which memberships in this LLC may be sold or otherwise transferred.

Date: _____

Signature: _____

Printed Name: _____

Spouse of: _____

Date: _____

Signature: _____

Printed Name: _____

Spouse of: _____

Date: _____

Signature: _____

Printed Name: _____

Spouse of: _____

Date: _____

Signature: _____

Printed Name: _____

Spouse of: _____

Date: _____

Signature: _____

Printed Name: _____

Spouse of: _____

Date: _____

Signature: _____

Printed Name: _____

Spouse of: _____

Limited Liability Company Management Operating Agreement

I. Preliminary Provisions

(1) **Effective Date:** This operating agreement of _____,
effective _____, is adopted
by the members whose signatures appear at the end of this agreement.

(2) **Formation:** This limited liability company (LLC) was formed by filing articles of organization, certificate of formation, or a similar organizational document with the LLC filing office of the state of _____ on _____.
A copy of this organizational document has been placed in the LLC's records book.

(3) **Name:** The formal name of this LLC is as stated above. However, this LLC may do business under a different name by complying with the state's fictitious or assumed business name statutes and procedures.

(4) **Registered Office and Agent:** The registered office of this LLC and the registered agent at this address are as follows: _____.

The registered office and agent may be changed from time to time as the members or managers may see fit, by filing a change of registered agent or office form with the state LLC filing office. It will not be necessary to amend this provision of the operating agreement if and when such a change is made.

(5) **Business Purposes:** The specific business purposes and activities contemplated by the founders of this LLC at the time of initial signing of this agreement consist of the following:

_____.

It is understood that the foregoing statement of purposes shall not serve as a limitation on the powers or abilities of this LLC, which shall be permitted to engage in any and all lawful business activities. If this LLC intends to engage in business activities outside the state of its formation that require the qualification of the LLC in other states, it shall obtain such qualification before engaging in such out-of-state activities.

(6) **Duration of LLC:** The duration of this LLC shall be _____.
Further, this LLC shall terminate when a proposal to dissolve the LLC is adopted by the membership of this LLC or when this LLC is otherwise terminated in accordance with law.

II. Management Provisions

(1) Management by Managers: This LLC will be managed by the managers listed below. All managers who are also members of this LLC are designated as "members"; nonmember managers are designated as "nonmembers."

Name: _____ ☐ Member ☐ Nonmember

Address: _____

Name: _____ ☐ Member ☐ Nonmember

Address: _____

Name: _____ ☐ Member ☐ Nonmember

Address: _____

Name: _____ ☐ Member ☐ Nonmember

Address: _____

Name: _____ ☐ Member ☐ Nonmember

Address: _____

Name: _____ ☐ Member ☐ Nonmember

Address: _____

(2) Nonliability of Managers: No manager of this LLC shall be personally liable for the expenses, debts, obligations, or liabilities of the LLC, or for claims made against it.

(3) Authority and Votes of Managers: Except as otherwise set forth in this agreement, the articles of organization, certificate of organization, or similar organizational document, or as may be provided under state law, all management decisions relating to this LLC's business shall be made by its managers. Management decisions shall be approved by _____ of the current managers of the LLC, with each manager entitled to cast one vote for or against any matter submitted to the managers for a decision.

(4) Term of Managers: Each manager shall serve until the earlier of the following events:

- (a) the manager becomes disabled, dies, retires, or otherwise withdraws from management
- (b) the manager is removed from office, or
- (c) the manager's term expires, if a term has been designated in other provisions of this agreement.

Upon the happening of any of these events, a new manager may be appointed to replace the departing manager by _____.

(5) Management Meetings: Managers shall be able to discuss and approve LLC business informally, and may, at their discretion, call and hold formal management meetings according to the rules set forth in the following provisions of this operating agreement.

Regularly scheduled formal management meetings need not be held, but any manager may call such a meeting by communicating his or her request for a formal meeting to the other managers, noting the purpose or purposes for which the meeting is called. Only the business stated or summarized in the notice for the meeting shall be discussed and voted upon at the meeting.

The meeting shall be held within a reasonable time after a manager has made the request for a meeting and in no event later than _____ days after the request for the meeting. A quorum for such a formal managers' meeting shall consist of _____ managers, and if a quorum is not present, the meeting shall be adjourned to a new place and time with notice of the adjourned meeting given to all managers. An adjournment shall not be necessary, however, and a managers' meeting with less than a quorum may be held if all nonattending managers agreed in writing prior to the meeting to the holding of the meeting. All such written consents to the holding of a formal management meeting shall be kept and filed with the records of the meeting.

The proceedings of all formal managers' meetings shall be noted or summarized with written minutes of the meeting and a copy of the minutes shall be placed and kept in the records book of this LLC.

(6) Managers' Commitment to LLC: Managers shall devote their best efforts and energy working to achieve the business objectives and financial goals of this LLC. By agreeing to serve as a manager for the LLC, each manager shall agree not to work for another business, enterprise, or endeavor owned or operated by himself or herself or others, if such outside work or efforts would compete with the LLC's business goals, mission, products, or services or would diminish or impair the manager's ability to provide maximum effort and performance to managing the business of this LLC.

(7) Compensation of Managers: Managers of this LLC may be paid per-meeting or per diem amounts for attending management meetings, may be reimbursed actual expenses advanced by them to attend management meetings or attend to management business for the LLC, and may be compensated in other ways for performing their duties as managers. Managers may work in other capacities for this LLC and may be compensated separately for performing these additional services, whether as officers, staff, consultants, independent contractors, or in other capacities.

III. Membership Provisions

(1) Nonliability of Members: No member of this LLC shall be personally liable for the expenses, debts, obligations, or liabilities of the LLC, or for claims made against it.

(2) Reimbursement for Organizational Costs: Members shall be reimbursed by the LLC for organizational expenses paid by the members. The LLC shall be authorized to elect to deduct and amortize organizational expenses and start-up expenditures as permitted by the Internal Revenue Code and as may be advised by the LLC's tax adviser.

(3) Members' Percentage Interests: A member's percentage interest in this LLC shall be computed as a fraction, the numerator of which is the total of a member's capital account and the denominator of which is the total of all capital accounts of all members. This fraction shall be expressed in this agreement as a percentage, which shall be called each member's "percentage interest" in this LLC.

(4) Membership Voting: Except as otherwise may be required by the articles of organization, certificate of formation, or a similar organizational document, by other provisions of this operating agreement, or under the laws of this state, each member shall vote on any matter submitted to the membership for approval in proportion to the member's percentage interest in this LLC. Further, unless defined otherwise for a particular provision of this operating agreement, the phrase "majority of members" means the vote of members whose combined votes equal more than 50% of the votes of all members in this LLC, and a majority of members, so defined, may approve any item of business brought before the membership for a vote unless a different vote is required under this operating agreement or state law.

(5) Compensation: Members shall not be paid as members of the LLC for performing any duties associated with such membership. Members may be paid, however, for any services rendered in any other capacity for the LLC, whether as officers, employees, independent contractors, or otherwise.

(6) Members' Meetings: The LLC shall not provide for regular members' meetings. However, any member may call a meeting by communicating his or her wish to schedule a meeting to all other members. Such notification may be in person or in writing, or by telephone, facsimile machine, or other form of electronic communication reasonably expected to be received by a member, and the other members shall then agree, either personally, in writing, or by telephone, facsimile machine, or other form of electronic communication to the member calling the meeting, to meet at a mutually acceptable time and place. Notice of the business to be transacted at the meeting need not be given to members by the member calling the meeting, and any business may be discussed and conducted at the meeting.

If all members cannot attend a meeting, it shall be postponed to a date and time when all members can attend, unless all members who do not attend have agreed in writing to the holding of the meeting without them. If a meeting is postponed, and the postponed meeting cannot be held either because all members do not attend the postponed meeting or the nonattending members have not signed a written consent to allow the postponed meeting to be held without them, a second postponed meeting may be held at a date and time announced at the first postponed meeting. The date and time of the second postponed meeting shall also be communicated to any members not attending the first postponed meeting. The second postponed meeting may be held without the attendance of all members as long as a majority of the percentage interests of the membership of this LLC is in attendance at the second postponed meeting. Written notice of the decisions or approvals made at this second postponed meeting shall be mailed or delivered to each nonattending member promptly after the holding of the second postponed meeting.

Written minutes of the discussions and proposals presented at a members' meeting, and the votes taken and matters approved at such meeting, shall be taken by one of the members or a person designated at the meeting. A copy of the minutes of the meeting shall be placed in the LLC's records book after the meeting.

(7) Membership Certificates: This LLC shall be authorized to obtain and issue certificates representing or certifying membership interests in this LLC. Each certificate shall show the name of the LLC and the name of the member, and state that the person named is a member of the LLC and is entitled to all the rights granted members of the LLC under the articles of organization, certificate of formation, or a similar organizational document; this operating agreement; and provisions of law. Each membership certificate shall be consecutively numbered and signed by one or more officers of this LLC. The certificates shall include any additional information considered appropriate for inclusion by the members on membership certificates.

In addition to the above information, all membership certificates shall bear a prominent legend on their face or reverse side stating, summarizing, or referring to any transfer restrictions that apply to memberships in this LLC under the articles of organization, certificate of formation, or a similar organizational document, and/or this operating agreement, as well as the address where a member may obtain a copy of these restrictions upon request from this LLC.

The records book of this LLC shall contain a list of the names and addresses of all persons to whom certificates have been issued, show the date of issuance of each certificate, and record the date of all cancellations or transfers of membership certificates.

IV. Tax and Financial Provisions

(1) Tax Classification of LLC: The members of this LLC intend that this LLC be initially classified as a _____ for federal and, if applicable, state income tax purposes. It is understood that, subject to federal and state law requirements, all members may agree to change the tax treatment of this LLC by signing, or authorizing the signature of, IRS Form 8832, *Entity Classification Election*, and filing it with the IRS and, if applicable, the state tax department within the prescribed time limits.

(2) Tax Year and Accounting Method: The tax year of this LLC shall be _____. The LLC shall use the _____ method of accounting. Both the tax year and the accounting period of the LLC may be changed with the consent of all members or all managers if the LLC qualifies for such change, and may be effected by the filing of appropriate forms with the IRS and state tax authorities.

(3) Tax Matters Partner: If this LLC is required under Internal Revenue Code provisions or regulations, it shall designate from among its members or member-managers a "tax matters partner" in accordance with Internal Revenue Code Section 6231(a)(7) and corresponding regulations, who will fulfill this role by being the spokesperson for the LLC in dealings with the IRS as required under the Internal Revenue Code and Regulations, and who will report to the members and managers on the progress and outcome of these dealings.

(4) Annual Income Tax Returns and Reports: Within 60 days after the end of each tax year of the LLC, a copy of the LLC's state and federal income tax returns for the preceding tax year shall be mailed or otherwise provided to each member of the LLC, together with any additional information and forms necessary for each member to complete his or her individual state and federal income tax returns. If this LLC is classified as a partnership for income tax purposes, this additional information shall include a federal (and, if applicable, state) Schedule K-1 (Form 1065, *Partner's Share of Income, Deductions, Credits, etc.*) or equivalent income tax reporting form. This additional information shall also include a financial report, which shall include a balance sheet and profit and loss statement for the prior tax year of the LLC.

(5) Bank Accounts: The LLC shall designate one or more banks or other institutions for the deposit of the funds of the LLC, and shall establish savings, checking, investment, and other such accounts as are reasonable and necessary for its business and investments. One or more employees of the LLC shall be designated with the consent of all managers to deposit and withdraw funds of the LLC, and to direct the investment of funds from, into, and among such accounts. The funds of the LLC, however and wherever deposited or invested, shall not be commingled with the personal funds of any members or managers of the LLC.

(6) **Title to Assets:** All personal and real property of this LLC shall be held in the name of the LLC, not in the names of individual members or managers.

V. Capital Provisions

(1) **Capital Contributions by Members:** Members shall make the following contributions of cash, property, or services as shown next to each member's name below. Unless otherwise noted, cash and property described below shall be paid or delivered to the LLC on or by _____. The fair market values of items of property or services as agreed between the LLC and the contributing member are also shown below. The percentage interest in the LLC that each member shall receive in return for his or her capital contribution is also indicated for each member.

Name	Contribution	Fair Market Value	Percentage Interest in LLC
_____	_____	\$ _____	_____
_____	_____	\$ _____	_____
_____	_____	\$ _____	_____
_____	_____	\$ _____	_____
_____	_____	\$ _____	_____
_____	_____	\$ _____	_____

(2) **Additional Contributions by Members:** The members may agree, from time to time by unanimous vote, to require the payment of additional capital contributions by the members, on or by a mutually agreeable date.

(3) **Failure to Make Contributions:** If a member fails to make a required capital contribution within the time agreed for a member's contribution, the remaining members may, by unanimous vote, agree to reschedule the time for payment of the capital contribution by the late-paying member, setting any additional repayment terms, such as a late payment penalty, rate of interest to be applied to the unpaid balance, or other monetary amount to be paid by the delinquent member, as the remaining members decide. Alternatively, the remaining members may, by unanimous vote, agree to cancel the membership of the delinquent member, provided any prior partial payments of capital made by the delinquent member are refunded by the LLC to the member promptly after the decision is made to terminate the membership of the delinquent member.

(4) No Interest on Capital Contributions: No interest shall be paid on funds or property contributed as capital to this LLC, or on funds reflected in the capital accounts of the members.

(5) Capital Account Bookkeeping: A capital account shall be set up and maintained on the books of the LLC for each member. It shall reflect each member's capital contribution to the LLC, increased by each member's share of profits in the LLC, decreased by each member's share of losses and expenses of the LLC, and adjusted as required in accordance with applicable provisions of the Internal Revenue Code and corresponding income tax regulations.

(6) Consent to Capital Contribution Withdrawals and Distributions: Members shall not be allowed to withdraw any part of their capital contributions or to receive distributions, whether in property or cash, except as otherwise allowed by this agreement and, in any case, only if such withdrawal is made with the written consent of all members.

(7) Allocations of Profits and Losses: No member shall be given priority or preference with respect to other members in obtaining a return of capital contributions, distributions or allocations of the income, gains, losses, deductions, credits, or other items of the LLC. The profits and losses of the LLC, and all items of its income, gain, loss, deduction, and credit shall be allocated to members according to each member's percentage interest in this LLC.

(8) Allocation and Distribution of Cash to Members: Cash from LLC business operations, as well as cash from a sale or other disposition of LLC capital assets, may be distributed from time to time to members in accordance with each member's percentage interest in the LLC, as may be decided by _____ of the _____.

(9) Allocation of Noncash Distributions: If proceeds consist of property other than cash, the _____ shall decide the value of the property and allocate such value among the members in accordance with each member's percentage interest in the LLC. If such noncash proceeds are later reduced to cash, such cash may be distributed among the members as otherwise provided in this agreement.

(10) Allocation and Distribution of Liquidation Proceeds: Regardless of any other provision in this agreement, if there is a distribution in liquidation of this LLC, or when any member's interest is liquidated, all items of income and loss shall be allocated to the members' capital accounts, and all appropriate credits and deductions shall then be made to these capital accounts before any final distribution is made. A final distribution shall be made to members only to the extent of, and in proportion to, any positive balance in each member's capital account.

VI. Membership Withdrawal and Transfer Provisions

(1) Withdrawal of Members: A member may withdraw from this LLC by giving written notice to all other members at least _____ days before the date the withdrawal is to be effective.

(2) Restrictions on the Transfer of Membership: A member shall not transfer his or her membership in the LLC unless all nontransferring members in the LLC first agree to approve the admission of the transferee into this LLC. Further, no member may encumber a part or all of his or her membership in the LLC by mortgage, pledge, granting of a security interest, lien, or otherwise, unless the encumbrance has first been approved in writing by all other members of the LLC.

Notwithstanding the above provision, any member shall be allowed to assign an economic interest in his or her membership to another person without the approval of the other members. Such an assignment shall not include a transfer of the member's voting or management rights in this LLC, and the assignee shall not become a member of the LLC.

VII. Dissolution Provisions

(1) Events That Trigger Dissolution of the LLC: The following events shall trigger a dissolution of the LLC, except as provided:

- (a) the death, incapacity, bankruptcy, retirement, resignation, or expulsion of a member, except that within _____ of the happening of any of these events, all remaining members of the LLC may vote to continue the legal existence of the LLC, in which case the LLC shall not dissolve
- (b) the expiration of the term of existence of the LLC if such term is specified in the articles of organization, certificate of formation, or a similar organizational document, or this operating agreement
- (c) the written agreement of all members to dissolve the LLC
- (d) entry of a decree of dissolution of the LLC under state law.

VIII. General Provisions

(1) Officers: The managers of this LLC may designate one or more officers, such as a president, vice president, secretary, and treasurer. Persons who fill these positions need not be members or managers of the LLC. Such positions may be compensated or noncompensated according to the nature and extent of the services rendered for the LLC as a part of the duties of each office. Ministerial services only as a part of any officer position will normally not be compensated, such as the performance of officer duties specified in this agreement, but any officer may be reimbursed by the LLC for out-of-pocket expenses paid by the officer in carrying out the duties of his or her office.

(2) Records: The LLC shall keep at its principal business address a copy of all proceedings of membership meetings, as well as books of account of the LLC's financial transactions. A list of the names and addresses of the current membership of the LLC also shall be maintained at this address, with notations on any transfers of members' interests to nonmembers or persons being admitted into membership in the LLC. A list of the current managers' names and addresses shall also be kept at this address.

Copies of the LLC's articles of organization, certificate of formation, or a similar organizational document, a signed copy of this operating agreement, and the LLC's tax returns for the preceding three tax years shall be kept at the principal business address of the LLC. A statement also shall be kept at this address containing any of the following information that is applicable to this LLC:

- the amount of cash or a description and value of property contributed or agreed to be contributed as capital to the LLC by each member

- a schedule showing when any additional capital contributions are to be made by members to this LLC
- a statement or schedule, if appropriate, showing the rights of members to receive distributions representing a return of part or all of members' capital contributions, and
- a description of, or date when, the legal existence of the LLC will terminate under provisions in the LLC's articles of organization, certificate of formation, or a similar organizational document, or this operating agreement.

If one or more of the above items is included or listed in this operating agreement, it will be sufficient to keep a copy of this agreement at the principal business address of the LLC without having to prepare and keep a separate record of such item or items at this address.

Any member or manager may inspect any and all records maintained by the LLC upon reasonable notice to the LLC. Copying of the LLC's records by members and managers is allowed, but copying costs shall be paid for by the requesting member or manager.

(3) All Necessary Acts: The members, managers, and officers of this LLC are authorized to perform all acts necessary to perfect the organization of this LLC and to carry out its business operations expeditiously and efficiently. The secretary of the LLC, or other officers, or one or more managers, or all members of the LLC, may certify to other businesses, financial institutions, and individuals as to the authority of one or more members, managers, or officers of this LLC to transact specific items of business on behalf of the LLC.

(4) Mediation and Arbitration of Disputes Among Members: In any dispute over the provisions of this operating agreement and in other disputes among the members, if the members cannot resolve the dispute to their mutual satisfaction, the matter shall be submitted to mediation. The terms and procedure for mediation shall be arranged by the parties to the dispute.

If good-faith mediation of a dispute proves impossible or if an agreed-upon mediation outcome cannot be obtained by the members who are parties to the dispute, the dispute may be submitted to arbitration in accordance with the rules of the American Arbitration Association. Any party may commence arbitration of the dispute by sending a written request for arbitration to all other parties to the dispute. The request shall state the nature of the dispute to be resolved by arbitration, and, if all parties to the dispute agree to arbitration, arbitration shall be commenced as soon as practical after such parties receive a copy of the written request.

All parties shall initially share the cost of arbitration, but the prevailing party or parties may be awarded attorney fees, costs, and other expenses of arbitration. All arbitration decisions shall be final, binding, and conclusive on all the parties to arbitration, and legal judgment may be entered based upon such decision in accordance with applicable law in any court having jurisdiction to do so.

(5) Entire Agreement: This operating agreement represents the entire agreement among the members of this LLC, and it shall not be amended, modified, or replaced except by a written instrument executed by all the parties to this agreement who are current members of this LLC as well as any and all additional parties who became members of this LLC after the adoption of this agreement. This agreement replaces and supersedes all prior written and oral agreements among any and all members of this LLC.

(6) Severability: If any provision of this agreement is determined by a court or arbitrator to be invalid, unenforceable, or otherwise ineffective, that provision shall be severed from the rest of this agreement, and the remaining provisions shall remain in effect and enforceable.

IX. Signatures of Members, Members' Spouses, and Managers

(1) Execution of Agreement: In witness whereof, the members of this LLC sign and adopt this agreement as the operating agreement of this LLC.

Date: _____

Signature: _____

Printed Name: _____ , Member

Date: _____

Signature: _____

Printed Name: _____ , Member

Date: _____

Signature: _____

Printed Name: _____ , Member

Date: _____

Signature: _____

Printed Name: _____ , Member

Date: _____

Signature: _____

Printed Name: _____ , Member

Date: _____

Signature: _____

Printed Name: _____ , Member

(2) Consent of Spouses: The undersigned are spouses of the members of this LLC who have signed this operating agreement in the preceding provision. These spouses have read this agreement and agree to be bound by its terms in any matter in which they have a financial interest, including restrictions on the transfer of memberships and the terms under which memberships in this LLC may be sold or otherwise transferred.

Date: _____

Signature: _____

Printed Name: _____

Spouse of: _____

Date: _____

Signature: _____

Printed Name: _____

Spouse of: _____

Date: _____

Signature: _____

Printed Name: _____

Spouse of: _____

Date: _____

Signature: _____

Printed Name: _____

Spouse of: _____

Date: _____

Signature: _____

Printed Name: _____

Spouse of: _____

Date: _____

Signature: _____

Printed Name: _____

Spouse of: _____

(3) Signatures of Managers: The undersigned managers of this limited liability company have read this agreement and agree to be bound by its terms in discharging their duties as managers.

Date: _____

Signature: _____

Printed Name: _____ , Manager

Date: _____

Signature: _____

Printed Name: _____ , Manager

Date: _____

Signature: _____

Printed Name: _____ , Manager

Date: _____

Signature: _____

Printed Name: _____ , Manager

Date: _____

Signature: _____

Printed Name: _____ , Manager

Minutes of Meeting of the

of

A meeting of the _____ of the above named limited liability company
was held on _____, at _____ M.,
at _____

_____, State of _____,

for the following purpose(s):

_____.

_____ acted as chairperson,
and _____ acted as secretary of the meeting.

The chairperson called the meeting to order.

The following _____ were present at the meeting:

_____.

The following persons were also present at the meeting, and any reports given by these persons are
noted next to their names below:

Name and Title

Reports Presented, If Any

_____	_____
_____	_____
_____	_____
_____	_____
_____	_____
_____	_____

_____ of the _____,
the following resolution(s) was/were adopted:

[illegible]

Date: _____

Name: _____

Title: _____

Certification of Authority

This LLC is managed by its _____. The names and addresses of each of its current _____ as of _____ are listed below. Each of these persons has managerial authority of the LLC and is empowered to transact business on its behalf.

Name of _____	Address
_____	_____
_____	_____
_____	_____
_____	_____
_____	_____
_____	_____
_____	_____
_____	_____

Further, each of the following _____ is specifically authorized to transact the following business on behalf of the LLC:

Date: _____

Name of LLC: _____

By _____

Printed Name: _____

Title: _____



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The forms in this book are available in two ways:

- on the CD-ROM or
- at www.nolo.com/back-of-book/LIAB7.html where you can instantly download all the forms.

To use the files, your computer must have specific software programs installed. Here is a list of types of files provided by this book, as well as the software programs you'll need to access them:

- **RTF.** You can open, edit, print, and save these form files with most word processing programs such as Microsoft Word, Windows WordPad, and recent versions of WordPerfect.
- **PDF.** You can view these files with Adobe Reader, free software from www.adobe.com. Government PDFs are sometimes fillable using your computer, but most PDFs are designed to be printed out and completed by hand.



TIP

Note to Macintosh Users. These forms were designed for use with Windows. They should also work on Macintosh computers; however, Nolo cannot provide technical support for non-Windows users.

Editing RTFs

Here are some general instructions about editing RTF forms in your word processing program. Refer to the book's instructions and sample agreements for help about what should go in each blank.

- **Underlines.** Underlines indicate where to enter information. After filling in the needed text, delete the underline. In most word processing programs you can do this by highlighting the underlined portion and typing CTRL-U.
- **Bracketed and italicized text.** Bracketed and italicized text indicates instructions. Be sure to remove all instructional text before you finalize your document.
- **Optional text.** Optional text gives you the choice to include or exclude text. Delete any optional text you don't want to use. Renumber numbered items, if necessary.
- **Alternative text.** Alternative text gives you the choice between two or more text options. Delete those options you don't want to use. Renumber numbered items, if necessary.
- **Signature lines.** Signature lines should appear on a page with at least some text from the document itself.

Every word processing program uses different commands to open, format, save, and print documents, so refer to your software's help documents for help using your program. Nolo cannot provide technical support for questions about how to use your computer or your software.



CAUTION

In accordance with U.S. copyright laws, the forms provided by this book are for your personal use only.

List of Forms

The following files are in Rich Text Format (RTF):

File Name	Form Title
articles.rtf	Articles of Organization
certify.rtf	Certification of Authority
filing.rtf	LLC Articles Filing Letter
minutes.rtf	Minutes of Meeting
opmanger.rtf	Management Operating Agreement
opmember.rtf	Operating Agreement for Member-Managed Limited Liability Company
reserve.rtf	Reservation of LLC Name Letter

The following is an Adobe Acrobat PDF file:

File Name	Form Title
f8832.pdf	IRS Form 8832: <i>Entity Classification Election</i>



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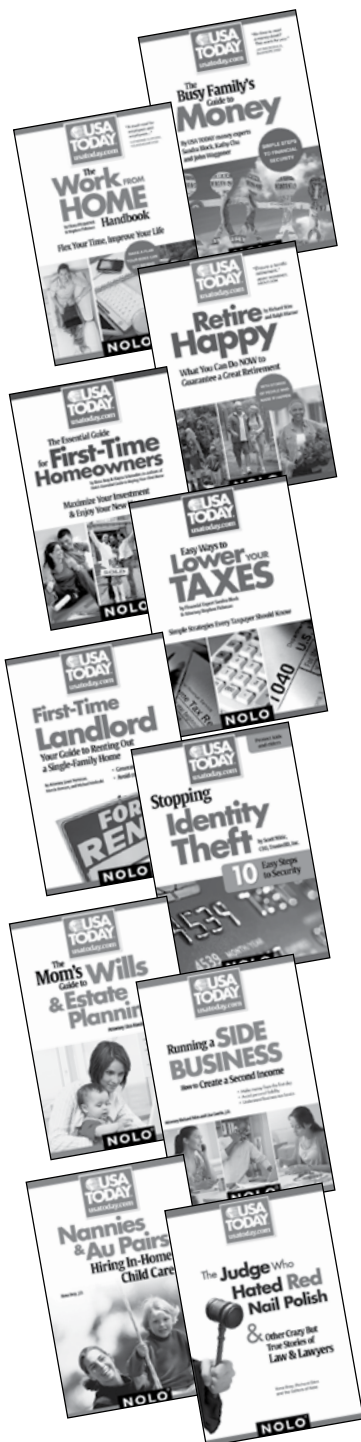
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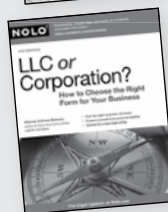
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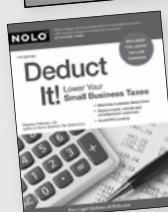
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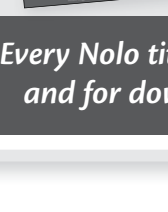
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